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REGULATORY COMPETITION, ECONOMIC REGULATION, AND LAW

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CHAPTER 1

INTRODUCTION

One often meets the view that economic regulation should be understood in terms of Pareto efficiency. Economic theories of law have traditionally focused on concepts such as market failure, efficiency, and inefficiency. Proponents assume that under the conditions of perfect competition, rational economic actors will enact courses of action that tend to induce Pareto outcomes. The idea of perfect competition means that markets which are competitive will induce efficient outcomes. The perfect competition approach has focused on the conception of market failure as the foundation for designing regulatory policy. Until recently, lawyers overwhelmingly relied upon a model of economic contract, developed over the last two decades in law and economics, as a normative structure to guide efficient decision-making.

As will be explained in this thesis, I do not share this view. While market failure views on the study of regulation have yielded a rich set of results on a number of areas centering on the implementation of market-like techniques for removing impediments to regulation, this research program has not dealt with complications that arise from incomplete information or the defects in institutional design. Yet, I believe that there is a political economic method for studying economic regulation — a method that can be employed for studying a wide array of regulatory relationships, from social regulation to the framework of financial markets. This method seeks to link two bodies of literature: the learning from the field of public regulation which seeks to highlight the formative role that process and structure rules play in the influence on the policy process and the new model of information economics which makes reference to limitations of policy choice due to asymmetrical information and strategic behavior (Laffont and Tirole 1993). Whether it takes the form of the contractual view of the corporation or focuses on the production of local public goods, I shall assess, throughout this thesis, the implications of this combined perspective for the nature and direction of regulatory policy and its implementation.

This thesis provides a new framework for thinking about the regulation of corporations and other kinds of institutions. In the past decade we have witnessed a transformation in the research on economic regulation. The changed emphasis has been influenced by a number of factors. Firstly, policy makers have been increasingly concerned with the stepped up performance of regulation, and how diverse regulatory processes impact the performance of industry. Second, the emphasis on regulatory performance has highlighted the concern that regulation has distributive consequences for the various industry groups and that the growing importance of regulation for many industries has generated a body of research which takes into account the political influence activities which invariably accompanies political choice and policy implementation. At a general level, the emergence of a new regulatory literature reflects a need to move away from an exclusive concern for correcting market failure to an approach which focuses on policy choice and implementation.

As we will see throughout this thesis, the political economy framework views regulation as demanded and supplied. The notion that there is a 'dual demand' aspect to regulation is taken to mean that the emergence of regulation in a legal system need not arise in response to correct a market failure. The basic idea of the new regulatory theory is that there are a number of features in the regulatory environment ranging from asymmetries of information to the choice of institutional structures which has complicated the design of regulatory mechanisms. Previously it was thought that we could avoid tackling the distributive consequences of regulatory policy by focusing on regulation through general equilibrium lens. But, due to the new body of research economic research in microeconomics and political science of organizations, which has taken into account moral hazard, adverse selection and political opportunism into the analysis of economic policy choice, our present set of analytical tools has improved our understanding of the set of regulatory possibilities. In this regard, the political economic approach acknowledges that certain aspects of regulation will be the result of opportunistic political behavior on part of either the regulatory agency or the regulated firms, or on the part of political interest groups. The fact that regulatory policies are subject to pressure has led to the rise of regulatory strategies (eg., actions) which attempt to limit opportunistic behavior by hardwiring institutional structures or developing incentive structures which make it possible for regulatory agencies to commit to a policy programme for an extended period (Laffont and Tirole 1993).

The application of the political economy approach to the study of regulation is the concern of this thesis. The chapters that follow do not seek to offer an exhaustive account of the new approach to the study of regulation. Rather the

approach taken here is limited to a study of how regulation has been developed and influenced by distributive influences. This thesis also will attempt to introduce the theory of repeated games in order to develop insights into the study of regulatory policy. This approach provides a means, in the presence of incomplete information, to determine which bargaining situations might provide a basis for the introduction of second-best regulatory policy. That is, repeated game models can assist in the search for a focal point which might yield a stable regulatory relationship. Finally, an attempt will be made to introduce the new generation of formal models concerning regulatory competition. These models redeploy the theory in a second-best world. In so doing, they sap the strength from the efficiency claims made in the context of legal federalism. Attention will also focus on the new models of regulatory capture which address the problems of informational asymmetry and provide productive grounds for altering the institutional features to make regulatory policies less sub-optimal.

1.2 Contractarian Theory

In the first part of the thesis I explore a form of economic regulation that treats the modern corporation as a 'nexus of contracts'. The 'contractarian' conception of the corporation is based on the insight that the firm is no more than an collection of contracts between labour, management, shareholders, and creditors. According to this view, the corporation does not differ in the economic sense from ordinary contractual relationships.

1.2.1 The Political Economy of Corporate Control

There are a cluster of economic theories of the firm which have contributed to the understanding of the law and economics of the corporation. The common core of these new ideas is that the institutional structure and internal governance are key elements in the firm's strategy, which determines its competitive success. Unlike the managerialist theories inspired by Berle and Means (1932), these micro-economic theories treat management as an agent for shareholders, and emphasize that internal and external monitoring devices are necessary to ensure the convergence of interests within the corporation. The managerialist theories had already emphasized the asymmetries of information due to diffusion of share ownership and managers' expertise and superior access to information, especially about the firm's assets. Yet the microeconomic theories went further when they emphasized the primacy of information for the optimal accountability of management. This account of the firm notes the important role of distorted information in the decision-making processes of management.

This new 'neo-classical' approach split between the institutional and the agency strands. The former emphasizes transaction costs, and concentrates on designing governance structures to deal with contractual hazards and the problem of bounded rationality. Agency theory, more radically, views the firm as a legal fiction serving as a nexus for a set of contracting relations among factors of production. It insists on abandonment of the notions of power and hierarchy within the firm, and sees management as involved in bargaining and carrying out a successive contracts. Since managers's functions of interpreting objectives and formulating plans may have given them considerable discretion for acting in their self interest, and given also the self-interest objectives of other agents, the governance task is to devise a set of incentives structures which tend to promote efficiency. Such pursuit of career concerns becomes a dominant theme as a typical cost associated with the principal-agent relationship, and provides a different angle on the analysis of the firms' structures, including hierarchy, as essential to reconcile the role of managers and others in the firm in relation to the residual risk-bearers.

In the 1980s, agency cost theorists argued that one of the primary mechanisms for disciplining management is the market for corporate control. The effectiveness of this technique has been the subject of considerable debate within the legal, economics, and finance literatures. The theory of corporate control is based on the proposition that where agents have specific human capital investments in the firm, their firm-specific wealth is threatened by a hostile acquisition of the firm that may bring in a new management team. Proponents of the benefits of efficient corporate restructuring, most notably Frank Easterbrook and Daniel Fischel (1991), argue that the threat of takeover itself is sufficient to induce managers to align their strategic action to meet the needs of shareholders. However, as I show in chapter 2, the empirical evidence of the market control is contradictory, and contains many ambiguities. In the first place, it has concentrated on the issue of whether the threat of hostile takeover reduces the non-value-maximizing actions of agents. Yet, I demonstrate that the post-merger studies in the US and UK show only slight differences in profitability between companies that became takeover targets and those that did not. There has been much less attention given to the extent to which takeovers provide a means for managers to maximize self-interest by value-reducing strategies, such as poison pills and other forms of dilution of capital. While this last point is an interesting one, there is recent evidence that suggests managers, despite the presence of the takeover mechanism, are able to entrench themselves further by making value-enhancing investments (e.g., takeovers) beneficial to the shareholder and incumbent management team respectively.

The structure of this latter argument is discussed, in chapter 2, in connection

with John Coffee's (1987) differential risk hypothesis. Coffee offers an alternative account for rapid rise of the market for corporate control in the 1980s: the asymmetry of risk between managers and shareholders. The relation between risk and the bargaining problem between shareholders and management is not confined to economics. While the pursuit of economic wealth undoubtedly motivated the bust-up merger movement of the 1980s, Coffee also offers a non-economic theory of corporations and the socially optimal level of risk in society. An argument can be made that the 1980s takeover wave introduced a higher level of risk for corporate stakeholders which, in response, created a ground swell response in political society for the protection of non-shareholder constituencies which were harmed as a result of the transfer of risk. Coffee argued that there were sufficient incentives for the corporations to lower their cost by paying compensation for the competitive harms caused to the losers from takeovers, since it has more to lose from the action of these interest groups. In chapter 2, I argue that Coffee's proposal does not have the stabilizing effects anticipated since managerial employees, the target of Coffee's proposal, have more effective means of protecting their interests in the takeover context.

Let me briefly point out that the relation between economics and politics in this case of takeovers was straightforward. I believe that the conflict over economic wealth formed the power base for political activity. There is enough evidence to demonstrate that the political structure of corporate decision-making was responsible for protecting stakeholders from shareholder opportunism in the late 1980s. I return to these issues in chapter 4 below. Here I only want to note that Coffee has made a powerful argument concerning the appropriate level of risk in the firm. In doing so he has also contributed to the joining of political science and economics into the political economy of corporate regulation. In simplest terms, this means the linkage of two lines of analysis to show that political and economic forces must be understood to contribute to shaping the structure of institutions. In this context, one might argue that on general theoretical grounds that there is a tendency in society for corporations to be influenced by market and political forces is not quite specific enough to explore the more technical questions concerning how the economic system produces regulatory institutions which respond principally to management-centered interests at the expense of other interests within the firm. In chapter 4 I examine more closely the capture theories of regulation which provide a useful basis for explaining the confluence of interests that promote corporate lawmaking that enhances both the professional intermediaries and managements' interests. In this thesis, I endorse an approach to law and economics that opens up the 'black boxes' of the maximizing models of individual economic and political behavior. One means of addressing the

obstacles to the design and implementation of long-term policy making is the introduction of contractual incompleteness and power to understand some important economic arrangements. I will touch on these concerns in chapter 3.

1.2.2 Incomplete Corporate Contracts

Corporate law theorists also look to the new economic theories as a framework for analyzing the conflicting interests within the firm. Proponents emphasize that there is no single a priori governance structure which is appropriate for all businesses. Rather the claim is that entrepreneurs must decide which combination of rules attract the highest level of corporate investment by interests outside the firm. Failure to locate the optimal mix of rules will result in higher costs relative to other firms, and in the long run only the least-cost corporations will survive. This approach, advanced by Easterbrook and Fischel (1991) combines two related theories (eg., agency cost and efficient market hypothesis), and states that managers have a high powered set of incentives to create legal rules and corporate structures that mimic the market.

Let me briefly point out that for proponents of contractarian theory, the primacy of contract implies that corporate law should contain no mandates, only default rules. In general terms the function of corporate law, on this view, is to design an efficient set of default rules (to deal with the potential for information asymmetries and barriers to collective action) to govern the rights and duties among directors, shareholders, and investors. It follows, therefore, that an efficient set of governance structures would include those background rules to which most parties would agree after a complete round of bargaining. The intuition behind this argument is that the legal-decision-making respecting firms should be treated as an exercise in contractual gap-filling pursuant to the 'hypothetical contract' principle, a universal norm to guide decision-makers in supplying default terms and filling gaps. Here, the hypothetical contract is based not on actual but counterfactual consent, i.e., what rational, forward-looking parties with perfect information would do for achieving these goals. Under the principle, the legal system supplies the rule which both parties to the contract would have adopted had they addressed the matter *ex ante* in a costless world. The contract terms which follow will be efficient in all circumstances. And, because the theory's operative class of contracts includes any and all voluntary economic relationships, the field deemed appropriate for application of its regime of *ex ante* default rules and gap fillers is quite large. In the final contractarian picture we get a complex of contract terms that govern all future contingencies, all derived *ex ante*, either in fact or hypothesis.

The contractarian paradigm has significant shortcomings. Contractarians assume that rational, well-informed parties will bargain to optimal contractual provisions. Let me mention that this argument assumes a theory of perfect bargaining (eg., complete information and perfect competition). It is clearly common that parties have less than perfect information. Moreover, the transaction costs approach has already shown that the presence of frictions often makes it difficult for parties to design contractual provisions. In chapter 3, I argue that the contractarian description of bargaining remains firmly tied to the complete contracts concept. Having explained in some detail the problems with a corporate governance system, based on a complete contracts picture of the firm, I move on to offer an alternative to the *ex ante* bargain approach to efficient corporate contracts.

From the foregoing characterization of contractarianism, it is clear that the fundamental theoretical task facing proponents is that of addressing the problems which arise when the idealistic construction fails. Under contractarians, parties are defined by certain normative ideals (i.e., rationality, utility-maximization, etc.) and their environment is designed to insure that their contract choices are consistent with their preferences. But we have reason to suspect that there are problems with the descriptive status of individual rationality under the theory. Contemporary game theory notes that rationality requires individuals to maximize their utility functions. Yet, in contemporary economies there are a variety of circumstances under which rationality fails or there is a determinacy problem with respect to the expected value of a choice. The contractarian account makes no attempt to provide a plausible explanation of complex rationality which individuals arguable seem to possess. The problem of rationality is more fully discussed in chapter 10.

In contrast to the complete contracts approach, one can work from the paradigm of incomplete contracts. In incomplete contract theory, the theorists assumes that it is difficult for parties to anticipate all the possible state contingencies that might arise, and design contractual provisions to deal with them. Proponents observe that even if the parties could specify all the relevant contingencies, the parties may find it difficult, if not impossible, to specify these future states in order to draft contract terms. Logically speaking, there may be so many contingencies to thwart the efforts of the parties of write them into the contract. In the case of verification and enforcement, it may be quite rational for parties to minimize their costs. Observe that these costs change the situation of *ex ante* contracting in that cost barriers may prevent parties from negotiating a complete *ex ante* solution to all problems.

The theory of incomplete contracts goes beyond demonstrating the limits of

complete contracting. From the point of view of corporate law theory, we introduce the ‘first principles’ paradigm of incomplete contracts as an alternative to contractarianism. Much of chapter 3 is devoted to a further analysis of this idea. Here I only want to stress that the first principles claim brings the notion of incompleteness to bear on a more precise notion of contract. To have an *ex ante* incomplete contract is due to the formal nature of the contract in addition to the costs of complete specification. What distinguishes the transaction cost approach from the first principles perspective is, first, the theorist looks to situations where a contract must be explicitly specified by its parties in order to be recognized as such and enforced. Secondly, I go on to argue that we have a contract if the contract terms are capable of computing all the possible future states. The fact that we lack the appropriate technology necessary to plan for certain contract problems implies that there are circumstances in which rational parties may proceed to trade without writing a contract at all.

In making the case for the first principles vision of corporate contracting, it might be said that we are arguing that optimality breaks down under uncertainty. Yet knowing that optimality breaks down does not necessarily prevent the theorist to defend an first-best equilibrium strategy. In order to address this concern, I introduce non-cooperative game theory as a technique for showing how coordination failures often shape the results of contractual bargaining. Broadly speaking, some game theory models are able to show that: (1) rational parties can adopt any one of a number of mutually consistent arrangements and market forces may fail to ensure that only the efficient pattern emerges from the possibilities; (2) that community supplied social norms may, under conditions of uncertainty, induce cooperative outcomes where no contract exists. I should point out that I have embraced game theory as a means to overcome some of the problems in the normative theory of corporate contract theory. To be sure, the theory of finitely and infinitely repeated games may not be capable of handling all the problems. Chapter 3 is largely devoted to a discussion of how game theoretic models of information can be imported into the real world of incomplete firm contracts.

The game theoretic approach provides a framework for a fundamental critique of the contractarian paradigm, ie., it builds on a model on the firm on actual arms length contracts and builds firm hierarchies on open-ended, non-contractual transfers of power. One may then move on to the insight that the game theoretic models, having shown that production follows from the possibility that trust may be reposed in an honorable actor, reveal that contracting can be neither expected nor demanded. That is, if we take into account contractual incompleteness, it becomes just as easy to assume that a contract might not

emerge from the bargaining process. Assuming, then, that these cases exist, we know that a functional justification for positive law is based on the insight that, since actors will not necessarily devise thorough-going contractual structures, the law should facilitate the production of a handful of mandates. Here, the introduction of traditional fiduciary standards is justified on normative and strategic grounds: they look to the firm's internal expectation's picture and broader notions about appropriate conduct in the world of firms.

The game theoretic approach is an advance on the earlier theory of contractarianism. I have mentioned that the contractarian perspective assumes that corporate law's only function is to save costs by supplying an *ex ante* terms which the parties would agree to under costless bargaining. *Ex ante* contracting is thought to be cost effective and sufficiently complete to solve the problem of self-interest by providing a satisfactory guarantee of legal protection. I will show in chapter 3 that complete contractual protection is not cost effective because, in the real world of complex contracting, there is unlikely to be a complete solution to contractual incompleteness. My suggestion is that the incomplete contracts paradigm, with its emphasis on information asymmetries and the recognition of multiple equilibria, opens up the way for the evolution of *ex post* incremental rules that might provide a more consistent and effective treatment of particular situations than the prohibitively expensive *ex ante* default rules. In the last section of chapter 3, I offer a typology of *ex post* default rules. This discussion closely parallels the discussion in the first part of chapter 3 about the relation between incomplete contracting and the solution to contractual incompleteness.

1.3 Regulatory Competition

The following discussion anticipates that of chapters 4 and 5, which provides further expositions of the central notions of devolutionary federalism. Here I only shall consider the assumptions of the theory and, in particular the respective paradigms of regulatory competition. I will leave to chapter 5 an evaluation of the efficiency view of regulation that favors competition across juridical limits as the basis for providing decisive support for devolutionary initiatives and first-best outcomes. Most of the policy implications are also more fully discussed in later chapters.

The reduction in barriers to trade and the liberalization of financial markets, transportation and telecommunications, have created the basis for the increase of flows of factors of production between jurisdictions. As countries move to a more liberalized domestic economy, questions of competition between jurisdictions abound. With the prospect of increased capital mobility, it is

becoming conventional wisdom that national governments should perform their economic policy functions more effectively since governments which yield optimal levels of public goods may be more successful in the competition between governments for attracting mobile resources. The concern to attract mobile resources has shaped entire areas of governmental policy and plays a determinative role for firms locating new plants. Arguments in favor of decentralization follow from the economics of competition between jurisdictions. Its influence has recently begun to be felt in other areas due to change of economic or political climate. Whatever the area, to consider the encouragement or discouragement of regulatory competition is to compare the relative benefits and detriments of allocating regulatory authority at a higher, including supra-national, or lower level of government.

These questions have long been relevant to the federal regime of the continental United States. They are now increasingly relevant to the emerging institutions of regional integration in the European Union, to other less developed regional integration processes, and to global institutions such as the WTO. Over the past few years most discussions of regulatory competition make frequent reference to the efficiency effects of decentralized policy-making. It hardly needs stressing that decentralization has many meanings and involves many separate issues (Stiglitz 1994: 154-56). We can refer to decentralization in terms of the assignment of decision-making from a centralized to a decentralized or local government. The theory of regulatory competition tells us that allowing for more decentralization helps to remove much of the asymmetrical information problems, reduces the prospects of capture, and enhances the introduction of a range of alternative solutions for similar problems. The economic advantages of decentralization undoubtedly provided a strong argument for politicians within federal systems to introduce the dynamic of diversity as a counterbalance to the discretion of central government (Weingast 1995: 21-2).

Regulatory competition is an economic theory of governmental organization that equates decentralization with first-best efficient results. The theory makes an analogy between law and commodities, and then asserts that lower level government — local, state, or national, as opposed to federal or supra-national — should compete for citizens and factors of production when they regulate. It predicts that such competitively-determined regulation will satisfy citizen preferences. The prediction has a normative implication for legal and political theory: Just as price competition disciplines producers of private goods for the benefit of consumers, so regulatory competition promises to discipline government producers for the benefit of taxpaying citizens. Regulatory competition has been brought to bear on the entire range of federalism discussions, usually

to support a devolutionary initiative or to oppose a proposal for federal intervention. The theory originated in public economics with the publication of the Tiebout model in 1956, which, in turn, influenced its own field profoundly. Theoretical arbitrage to legal contexts occurred early in the history of law and economics. But, in contrast to regulator competition's development in its home field, where it remained closely tied to the study of the production of public goods by state and local governments, lawyers in the United States have applied it across an expanse of subject matter, from corporate law to banking to environmental law and trade law. The cumulation of these exercises transformed federalism theory — regulatory competition came to be acknowledged as a basic federalism value.

After thus becoming a fixture on the landscape of American federalism, regulatory competition expanded to venues world-wide. It has been brought to bear within other federal and quasi-federal systems. Most notably it has figured in discussions on strategies for integration with the European Union (Easterbrook 1994: 12), especially in the context of the centralization versus subsidiarity debate crucial to many countries in the Union. The European Union Treaty agreed by the European Council at Maastricht in 1991 provides that a number of regulatory functions should be placed at the local and not at the central government level. Yet, a prominent feature of the Maastricht Treaty is the transfer of a number of regulatory functions to the Community level. One justification for this policy is that market integration requires that national monetary and fiscal policy be co-ordinated by a centralized institution (Edwards and Kenan 1996).

The post-Maastricht debate has given rise to two divergent positions concerning the optimal allocation of political and economic power in the EU. The debate over the appropriate location of power is conducted in the domain of efficiency, equity, and accountability. On the one hand, the decision to centralize policy at the federal level is primarily defended on the basis that it permits the Community to internalize significant spillovers by redistributing the risk across regions (Inman and Rubinfeld 1996). There are also some theorists who regard liberalization as a strategy which leads to pressures to reduce the level of protection on social-protection issues (Langille 1996). On the other hand, decentralized policies provide incentives for states to commit to efficiency-enhancing regulation. Subsidiarity favors the view that economic policy making should be restricted to lower-levels of government unless there exist credible circumstances for regulatory power to be centralized (Woolcock 1996: 290). What subsidiarity captures is the sense that the competition between jurisdictions provides a counterbalance to the drive for enhanced integration based on centralized co-ordination of national laws and policies (Bratton et al 1996).

In the debate over whether to undertake regulation by a central or a lower level authority, proponents of legal federalism look to the economic theory of jurisdictional competition to provide decisive support of devolutionary initiatives. Proponents of deregulation insist that there is a strong connection between decentralization, competitive behavior and efficient results. Regulatory competition is thought to follow from a robust economics that supports two general assertions. First, competitive forces shape a wide range of regulatory outcomes at state and local levels because menus of regulation figure significantly in the location decisions of citizens and factors of production. Second, the competition results in a market that equilibrates regulatory outcomes and citizen preferences. Two conditions must obtain, however — the lower level regulation must not generate significant externalities and borders must remain open for the free movement of capital and labor (Easterbrook 1994: 127, 129). Given satisfaction of the conditions, the lower level market for regulation (if left free to operate by central government) will provide an ‘empirical answer’ to important policy questions, since only the public goods and regulatory restrictions for which citizens are willing to pay will survive (Weingast 1996: 5). Central government intervention inhibits the operation of the market, and therefore is at best unnecessary and at best worst results in deadweight anti-competitive costs. There emerges a presumption in favor of locating regulatory authority at lower level units (Revesz 1992).

Yet, devolutionary federalism is highly contestable. By that I mean that current economic theory, in fact, supports neither the sequence of assertions nor the bottom line presumption in the theory outlined above. In doing so we do not deny the existence of regulatory competition, however. There are entire areas of law which manifestly have been shaped by competition. State and local governments also making taxing and spending decisions where competition clearly plays a determinative role — stadium deals for professional sports teams and tax breaks for firms locating new plants being the obvious examples. Nor do we deny that competition can have beneficial effects. Nor does our argument imply wholesale rejection of the body of legal scholarship on regulatory competition. To the contrary, we argue that situation-specific legal applications provide a useful source of material for demonstrating the theory’s shortcomings. We even argue that regulatory competition appropriately may be term a federalism value, at least at a broad structural level.

But we do argue that legal regulatory competition theory takes the occurrence of competitive behavior within federal systems as the basis for making two unjustified predictive leaps. The first is its general prediction that decentralization by itself assures that competition will be the formative influence on the terms of regulation. In our view, this finds no support in either the recog-

nized set of competitive lawmaking situations or the economic theory of regulatory competition. Although some regulatory subject matter is structurally suited to competitive influence, much regulatory subject matter is not so suited. The theory's questionable prediction is that, assuming a decentralized regulatory regime subject to competitive influence, competition will lead to a first-best regulatory equilibrium. Current economic theory, however, presents no solid basis for predicting any regulatory equilibria at all, much less first-best ones. The theory, in short, overstates the connection between decentralization, competitive behavior, and efficient results. There is no economic support for global pronouncements about the location of relative regulatory advantages within a federal system. Similarly, if we move to regional and even global levels, economic theory does not necessarily support leaving regulatory authority at the nation-state level. Under certain conditions, regional or global governance may produce better outcomes. The EU, NAFTA, APEC or even global institutions such as the WTO may be first best alternatives, but these cannot be simply understood through theories of regulatory competition.

1.3.1 Paradigms of Regulatory Competition

Among lawyers there is a widespread resistance to evaluate the assumptions of regulatory competition theory. Some of the reasons underlying this attitude are quite respectable, others are less so. Some are quite general, others are more specific. They will become much clearer as I proceed with a general account of the theory, which I shall return to in Chapter 5.

The leading economic model of regulatory competition (Tiebout 1956) centers on a different mobile factor — the individual, taxpaying citizen. It focuses on citizen-voter tastes for local public goods in the hypothetical context of a city resident contemplating a move to the suburbs and choosing among a number of towns. The model makes three assertions. First, locational decisions will reveal individual preferences for public goods and levels of taxation. Rational forward-looking individuals, after surveying the range of available choices, will act in accordance with their preferences for location-specific bundles of public goods. Second, a local public goods equilibrium can be established if, like producers of private goods, local government units compete with their public goods offerings to attract in-migration. Third, the promotion of competition between local governments should lead to an optimal balance between the level of taxation and the provision of local public goods. Given all this, there arises a general presumption favoring the provision of public services at the local level.

1.3.1.1 The Public Interest Theory of Regulation and the Race to the Bottom

When the Tiebout model first appeared four decades ago, it must have sounded a jarring note in the context of the prevailing ‘public interest’ theory of regulation. Public interest theory emphasized the government’s role as a benevolent maximizer of social welfare in the provision of traditional public goods and as economic regulator (Laffont and Tirole 1993: 476). Centralization often seemed to be the best way to realize the public interest. It was particularly likely to be the appropriate remedy for market failures — events deemed likely to occur by those who subscribed to this theory of government. And, given a democratic political framework, centralization was not of itself deemed to have dangerous properties. Any expansionary tendencies would be checked as citizens expressed their preferences in the context of interest group competition in the political process.

If one takes this public interest perspective, regulatory competition under the Tiebout model threatens betrayal of the public interest. With competition, the context of regulation and level of public goods and taxation are dictated by private preferences of a narrow, arbitrarily identified class of at-the-margin consumers, instead of following from a dispassionate and responsible calculation of the public welfare. Policy inquiry is diverted from a proper focus on the quality of the rules to an exclusive preoccupation with the processes that bring the rules into existence.

This negative response expands into a race to the bottom picture of regulatory competition. The race goes downwards because competition forces the pursuit of policies farther and farther removed from the public trust. The American corporate law system has been held out as the leading example. Under this view, charter competition has the perverse effect of causing the states to adhere less and less strongly to a productive shareholder norm of shareholder wealth maximization. And the remedy suggested is centralization-chartering by the national government (Cary 1974).

The race to the bottom characterization invites advocacy of pre-emptive centralization initiatives. If a race must go to the bottom, then the regulatory subject matter should be removed to a higher level of government, whether or not competition presently determines the content of regulation at the lower levels. Stewart (1977) used this argument to justify the federalization of US environmental law. According to Stewart, without centralization, competition for production factors would leave the states in a prisoner’s dilemma respecting environmental standards. Each state would be deterred from promulgating

standards at its preferred level of strictness by threat of a loss of production factors to a defecting competing state. The more intense the competition for factors, the greater the disparity between the level of environmental protection in the public interest and that evolving in practice. Furthermore, given the multiplicity of states, the transaction costs of collective action would prevent co-ordination; the prisoner's dilemma accordingly ripens into a commons dilemma.

American regulatory conflict has been widely discussed in Europe (Majone 1991). It is not surprising, therefore, that the concern that the competition between governments could lead to a race to the bottom influenced EC policy-makers in developing an approach to regulation that limited the intensity of competition between governments. In the EU, the introduction of relatively high regulatory floors would reduce the ability of national governments to compete for mobile factors of productions. Article 100a of the EEC Treaty set forth minimum essential standards with respect to consumer protection, environmental protection, health and safety. Similarly, the EC adopted a 'new approach' to harmonization which sought to overcome the limitations of the *ex ante* harmonization approach while providing a loose form of European-level regulation. The effort to introduce minimal levels of regulation is expected to restrict the outbreak of competitive deregulation by member states. It must be stressed that the 'new approach' requires transfer of regulatory authority to a centralized regime. But this does not mean that the harmonization of essential minimum rule leads to uniform regulation. Mutual recognition of national regulatory requirements ensures that, once common levels are established, national regulators can provide different menus of regulation tailored to preferences of consumers. Evidently, the aim of mutual recognition is to stimulate the competition among national governments in order to provide for flexibility and innovation. In this regard, the 'new approach' creates a dynamic of interaction between national rules and Community-level harmonized regulation (Woolcock 1996: 292-97).

1.3.1.2 Public Choice, Social Choice, and the Race-to-the-Top

The public interest perspective that prompted objections to the claims of regulatory competition theory itself came to be challenged by two other theories of government — public choice and social choice. These took the position that the 'public interest' cannot be meaningfully articulated in the first place, much less utilized as a template for regulation (see also chapter 5 below).

Social choice theory, as originally articulated, asserted that the public interest

does not emerge in political practice because voting paradoxes prevent the emergence of a preference ordering for public goods, and predicted that no technical adjustment of democratic processes could solve the problem. Regulation, accordingly, does not embody a 'public interest' in the sense of an aggregation of the preferences of the electorate. Public choice theory added that actors were likely to misrepresent their preferences in the discourse of democracy. The free rider problem that comes up in the arena of collective political action makes it rational for an actor to misstate the level of his or her demand for public goods.

Public choice theory goes on to account for the substantive content of regulation as the reflection not of the public interest but of multifarious private interests. The theory asserts that actors rationally employ the government and form groups to influence it. Lawmaking in turn follows the demand patterns of these interest groups as risk averse lawmakers respond to the dominant voices (Olson 1965). Producers, in particular, are likely to seek to register demands on lawmakers, looking for subsidies, import quotas, tariffs, price regulation, or government-created barriers to entry, such as licensing requirements (Stigler 1971). This private rent-seeking activity prompts competition among government actors to become rent distributors and receive interest group favors (Buchanan 1980; Tollison 1982). Dead-weight social losses result. Furthermore, government actors, particularly central government actors, tend to assume a monopolist's position respecting the provision of public goods and pursue the objective of governmental revenue maximization (Brennan and Buchanan 1980: 17-24). A positive relation obtains between the degree of centralization and the size of government, measured in terms of the budget. Given the uncertainties of majority rule cycling, the rational ignorance of voters, and confusion amongst politicians (*ibid.*; Mueller: 268), political controls will not be equal to the task of containing government growth. Thus, the provision of public goods will reflect not the utility level of the average taxpayer, but that of the expanding state.

Under this social choice/public choice diagnosis of the infirmities of democratic government, capture and excess government growth flourish when discourse about the public interest prevails in lawmaking contexts. The rhetorical equilibrium (Easterbrook 1994: 128) conceals the determinant rent-seeking. At this point, the Tiebout model, with its local public goods equilibrium prompted by jurisdictional competition, appears in the picture to offer a theoretical cure. The cure follows from the microeconomic proposition that market transactions are the most accurate allocators of social resources. Law, accordingly, should arise not from discussion of the public interest but from the response of at-the-margin producers. At the same time, the model's market-driven lawmaking

equilibrium solves the problem of preference aggregation that social theory identifies.

The Tiebout model also implies a practical recommendation tracking that of public choice analysis. But look to devolution of regulatory authority to lower levels of government. Regulatory competition presupposes horizontally-situated government units; regulatory competition theory adds that the revenue enhancement constrains that prompt competitive response to citizen (and customer) preferences are likely to be felt with more intensity at lower levels of government. By increasing the lower units' subject matter jurisdiction, decentralization expands opportunities for competitive lawmaking.

Significantly, many of the benefits thus claimed for centralization obtain whether or not it precipitates an outbreak of competition. Reducing the size of the regulating unit narrows the variance in the distribution of preferences, reduces the likelihood that preferences will be bundled and ameliorates some problems of asymmetrical information. Regulation, thus adapted to local conditions, is more likely to approach the ideal consonance with citizen preferences. At the same time, decentralization increases the chance that a diverse range of preferences will come to be manifested in regulation prompted by one or another jurisdiction. The localized experimentation thus fostered, makes it possible for a range of regulatory strategies to appear, while simultaneously limiting the negative impact of unsuccessful experiments.

Finally, decentralization reduces the scope of central government monopoly and ameliorates the negative effects of regulatory capture. Capture leads to bigger dead-weight costs when authority is exercised at higher levels of government. Local authorities have a lesser capacity to damage the economy. They cannot impose tariffs and quotas on imports; their licensing arrangements have a limited reach; and their limited resources reduce the capacity to offer significant subsidies. Incentives to interest groups, accordingly, decrease as authority vests in lower levels. Of course, these units remain subject to small-scale influence activities. But, at this point, horizontal competition can have a disciplinary effect that minimizes the losses stemming from capture arrangements. Given mobility of people and factors, the imposition of costly and restrictive interest group legislation in one jurisdiction benefits a neighboring jurisdiction with a less costly regime. As the factors vote with their feet, they affect the incentives of lawmakers — inefficient wealth transfers to favored groups become less attractive than regulations that enhance the wealth of the larger population.

The list of relative advantages of decentralization and competition coalesces

into a race-to-the-top when projected into the standard Darwinian evolutionary framework of microeconomics. Thus extended, the Tiebout model promises an efficient allocation of industrial activity among horizontally-situated jurisdictions (Revesz 1992: 121-22). In a dynamic environment, the competitive forces that achieve this result should assure that only efficient regulation continues in effect (Trachtman 1993). Over time, then, competition raises the standards of all regulation.

1.3.2 The USA Corporate Law as a Paradigm Case

Chapter 4 articulates the building blocks of the state law system of corporate law as a self-regulatory system composed of firms and state lawmaking institutions, in which competition among the states ensures the system's capture by corporate management influence. This chapter draws on political and economic theory to provide a guide for dealing with the system's capture by management influence activities.

US corporate law is a subject matter uniquely-suited to the evaluation of the presumption that market controls ensure that efficient governance structures result as the states respond to managements' demands. because it is a rare jurisprudence which has been shaped by competitive forces for an extended period. Of course, competitive forces actively shape many regulatory regimes within the US, the EU, and internationally. But these cases can be subdivided into two broad categories, with structural impediments to competition bearing more or less strongly depending on the category. In the first category, conflict of laws rules allow firms or individuals to select among a number of jurisdictions for the situs of a legal relationship, and the jurisdictions compete for their business. In the second category, public or private product competition across jurisdictional lines prompts competitive lawmaking by governments either pursuing new residents or factors of production or attempting to confer competitive advantages on existing factors. With the first category it is relatively easy to show that limited mobility, information asymmetries, product bundling, and government incentives present no insurmountable barriers to competition; with the second category no such presumption obtains and any showing falls into the first category, along with family law, and such phenomena as offshore tax havens and international ship registration.

American corporations may choose their state of incorporation without regard to the location of the firm's physical assets — the commerce clause of the federal constitution was interpreted to assure this result. At least as to larger firms, conditions for competitive lawmaking clearly obtain. Mobility, which is effectuated through reincorporation to another state, is not costless, but is

relatively cheap for larger firms; large law firms effectively serve as information intermediaries; the legal product offered is unbundled because reincorporation triggers only the application of the chartering states' corporate law; and an incentive to compete can be identified on the supply side, at least in the case of Delaware, the market leader. Delaware has been competing actively for chartering business for a century, along with a handful of less successful states. It offers reincorporating firms an attractive code and ancillary services in exchange for franchise tax revenues. Other states over time tend to bring their codes into line with that of the market leader.

A long-established division between federal and state regulatory functions has let this competitive process go forward with substantial interference from central government. State competition began in the 1890s, when New Jersey, followed by Delaware, enacted codes designed to appeal to the interests of the then new mass-producing corporations. Although some observers took a dim view of this management-friendly legal regime, its effects were not generally deemed to be incompatible with national economic policy pursued under antitrust and other federal regimes. But the climate became less favorable when ownership and trading of corporate securities became widespread beginning in the 1920s. A new centralized initiative occurred with the enactment of the federal securities laws in the 1930s. Even this, however, was structured so as to leave the state authority over internal corporate matters largely unimpaired.

Federal regulation of the securities markets coincided with a renewed debate over management legitimacy. This debate had negative implications for the competitive state system and its management customers. Berle and Means constructed an influential, politicized picture of the large corporation. They identified management as a powerful group, and showed that its power stemmed from a juridical model of corporate structure grounded in state law. The traditional state law model of corporate ownership and structure, combined with the new development of widespread and passive security holding, had left management in an unintended position of strategic dominance and accountable to no one. Cary brought this Berle and Means perspective to bear on a study of Delaware's regulatory product and concluded that the race had gone 'to the bottom'. To Cary, corporate law implicated the public interest; therefore, revenue maximization was an inappropriate motive for the state taking the lead in its creation. He suggested federal preemption as a remedy.

Regulatory competition theory stood ready to provide the basis for a counterstory. Winter drew on it to assert that charter competition had resulted in a 'race to the top'. Under this view, the chartering system is a market in which firms purchase corporate status and corporate codes in exchange for

franchise tax payments. Reincorporating firms are the markets marginal consumers, with the firms presently incorporated in each state holding out a constant threat of departure through reincorporation. The result is a constraint on the ability of any state to impose inefficient regulations and a system that efficiently matches the preferences of corporate consumers with the terms of regulation.

The ‘race to the top’ view strongly influences US discussions of corporate regulation. Corporate competition is generally recognized to have desirable results. But significant negative effects of shareholder value also are acknowledged. During the 1980s the states raced to accommodate the management interest with antitakeover legislation, impairing the operation of the principal market check on the agency costs of corporate organization. Delaware, historically the leading jurisdiction respecting management-protective innovations, took an uncharacteristic follower’s role with these and related innovations. These two developments — the systems’ ready provision of interest group legislation detrimental to the interests of equity investors and Delaware’s position as a follower respecting these legislative innovations — present key problems for the current discussions. The solutions eventually articulated will have important policy implications for regulatory competition theory as a whole. Here is a competitive lawmaking regime little impaired by problems of limited mobility, asymmetric information, bundling, and a lack of entrepreneurial incentive.

Yet, even the regime’s proponents agree that it has not fulfilled the theory’s promise of lawmaking free from undue influence. In addition, no consensus has emerged on a precise description of the incentive structure that determines regulatory outcomes within the system. Until that consensus emerges, debate will continue on the question whether the system makes good on the theory’s promise of regulatory innovation directed to the preferences of the actors with interests at stake.

1.3.2.1 Supply-Side Problems in the Production of US Corporate Law

As noted earlier, regulatory competition theory promises diminished regulatory capture and product innovation. Questions about the charter competition system’s delivery on the former promise have been asked since Cary leveled the charge of a race-to-the-bottom. In chapter 4 these questions are addressed.

Regulatory competition theory lost some of its explanatory credibility for corporate law when its proponents were forced to carve out an exception for the renewed management-protective antitakeover legislation of the 1980s.

Renewed allegations of regulatory capture followed. Bebchuk argued that transactions in the charter market are directed only to the preferences of the managers who control reincorporation decisions, and those preferences do not necessarily serve as proxies for the result that maximizes shareholder value. As a remedy, he revived Cary's suggestion of federal fiduciary standards. We expand on Bebchuk's analysis, but reach a different conclusion respecting the appropriate remedy.

We begin by arguing that the conflicting interests of shareholders and managers make reincorporation a form of mobility that does not effect a matching of regulation and consumer preferences. Although firms can exit from unsatisfactory jurisdictions, their shareholders have no power to force them to do so. Most state codes contain mandatory process rules assuring this result. Chapter 4 looks to capture theories of legislation and administration to explain this arrangement.

With reincorporation as the at the margin transaction, process rules that vest that exit decision in management bond the chartering state to continue solicitude to the management interest. Given a state thus bonded, management has no collective action problem when it comes to securing legislation favoring its interests — the state's organized bar performs that job voluntarily. The system at the same time exacerbates the collective action problem of the shareholders. Dispersed in the first place, they have no necessary ties to the chartering state. The bar shares their interests only to the extent that litigable, fee-generating legal rights result, but has no stake in designing a legal system that minimizes agency costs. Meanwhile, a constant threat of federal intervention, a negative development in the eyes of the systems's advocates, ameliorates the capture problem. A weak dual demand model results: Delaware, the state with the most to lose in the event of federalization, makes gestures in the direction of shareholder protection in order to defuse the threat.

However, we part company with the critics of the system who advocate that the federal government follow through on the threat and impose national fiduciary standards. Federal intervention could destroy the principal benefits of the Delaware-based system. With state corporate codes in substantial harmony, Delaware maintains its position by providing a corporate dispute resolution center of extraordinary sophistication. The incentives and rents that support its position as an information repository would dissipate with federalization. It is suggested that a dual demand model constituted of shareholder threats rather than federal threats would improve matters and that the federal government intervene to effect this result. Drawing on administrative law models that recommend interest group empowerment as a remedy for

agency capture, they recommend federal preemption of process rules that prevent shareholder initiatives to amend corporate charters and effect reincorporation.

A new group of players on the American corporate stage (eg., the politicized agents of investment institutions) is looked to provide a class of entrepreneurs who would put such an initiative privilege to use. It is projected that a grant of standing to these shareholder representatives to set the legislative agenda within corporations would reorder the incentives of state politicians and lawyers, forcing them to listen to the shareholder voice. Corporate law would remain subject to state subject matter, but managers no longer would have unilateral power to set the agenda. Accordingly, competition and the benefits following from its, far from being stifled by this central government mandate, would intensify.

The introduction of role of institutional investment managers as crucial players in the contestability game has additional consequences. The new players, once institutionalized, can become an effective force in causing corporations to become more effective. The commitment to introduce conflict into the regulatory game plays a central role in the collection of information and the provision of incentives in corporations as well as in public life. The implication of our theory is that a form of conflict is crucial to the development of a highly effective regulatory regime.

1.3.3 The Limited Liability Company and Regulatory Competition

So far I have discussed the leading paradigms of regulatory competition in respect to whether competitive lawmaking can discipline governments that produce law and come up with innovations that better satisfy the preferences of taxpaying citizens. I evaluated the general assertions of the competitive race-to-the-top and race-to-the-bottom in the context of US corporate chartering. We have shown that the corporate law example reveals that a distortive incentive structure can operate. The capture risk runs contrary to the general assertion that devolution of regulatory authority leads to competitive efficiency. In this context, it becomes very difficult to defend the idea competing jurisdictions produce first-best law. In chapter 6 considers the suggestion that the Limited Liability Corporation (LLC) is efficient due to the presence of competitive influences in the state law system. In this section, I now want to focus on some of the economic arguments upon which the efficiency claims rest, and point to some of the arguments against the presumption that the LLC is evolving so as to provide cost-effective limited liability for small firms.

The past decade has witnessed the dramatic emergence of a new business form in the United States. The LLC which is a combination of one-tier tax treatment, limited liability, and flexibility respecting governance terms, appears to improve the menu of business forms in certain respects. The LLC brings us to the final stage of in the evolutionary abandonment of the historical association of, on the one hand, limited liability, corporate governance norms, and two-tier tax treatment, and, on the other hand, unlimited liability, partnership governance norms, and one-tier tax treatment. The substantive justifications for bundling the first trio lost their force many years ago when limited liability, quasi-partnership governance norms, and one-tier tax treatment became available to actors who elected Subchapter S status and made full use of close corporation provisions in state codes. At the same time, corporate law has abandoned mandatory imposition of its board-level, collective decisionmaking norm without concern for the resulting expansion in the number of firm enjoying limited liability. Thus, there appears no compelling reason against the expansion of the menu of governance options available to firms doing business under the shield of limited liability.

1.3.3.1 The Law and Economics of Limited Liability

Before I turn to consider the LLC's proponents assertion that regulatory competition justifies the efficiency effects of the ownership structure, let me say something about the economics of limited liability. There would appear to be three main premises underlying the concept of limited liability. On this view, limited liability is thought to foster efficiency by lowering the cost of shareholding monitoring, reducing the risk of investment, and creating the conditions for the free transferability of shares. These effects are said to permit shareholder portfolio diversification which in turn prompts more productive investment policies within firms.

The thinness of this efficiency view becomes apparent when reference is made to a contrasting law and economics theory, the pro rata hypothesis. Proponents of this view assert that most of the problems of unlimited liability identified by efficiency theory are solved if a regime of unlimited liability abandons the joint and several rule of partnership law in favor of a rule of pro rata liability based on and limited by the proportion of equity owned by each shareholder. The advantages of the pro rata regime rest on three assumptions: (1) investors would not have to monitor one another's levels of wealth and would have incentive to diversify; (2) the present system's perverse incentives to invest in suboptimally risky production functions would be eliminated; and (3) the prospect of unlimited liability will not adversely affect the role of shareholding in the financial system and could serve to enhance firm performance. No doubt

the pro rata view directly and strongly challenges all the justifications for limited liability for small firms. Yet, LLC proponents thus far have failed to address this hypothesis.

I now want to inquire into the more substantive economic aspects of limited liability. The larger context of efficiency theory is derived from assertions prominent in the theory of the firm as propounded ten or fifteen years ago. Efficiency theory is rooted in these assertions today. The fact that the theory of the firm has moved on has implications for the assertions central to the claims of efficiency theory. The central claim behind the efficiency theory is the idea that there is a connection between a single firm ownership structure and the maximization of firm value. From the point of view adopted here, there are good reasons for thinking that there is little evidence to support this relationship. More specifically, some models show that an incentive device can provide a sufficient economic basis to align management incentives and limit the effects of risky decisions. Other models show that under certain conditions concentrated shareholding may have productivity advantages. Together these models sharply controvert the assertion that limited liability enhances productivity by discouraging concentration and by encouraging diversification. Much of the first part of chapter 6 is devoted to a further analysis of these models with regard to the relationship between liquidity and monitoring. Here I only want to stress that the efficiency theory's claims about diversification and productivity may be countered by line of inquiry which suggests that unlimited shareholder liability is feasible and holds potential productivity benefits for large firms.

I now turn to the encounter with the LLC proponents contention that the economic theory of regulatory competition justifies the adoption of LLC statutes on a nation-wide basis. Here I only want to re-state that, based on our earlier discussion of the manifest case of market failure in charter market, proponents of the market-based race school cannot plausibly rely on a black box inquiry into the LLC market that avoids inquiry into the incentives of government actors. Given this perspective, the second part of chapter 6 goes on to analyze the LLC situation in terms of a domestic law as product situation with regard to the classic race to the top story in which fifty states compete to supply cost-saving business forms to an undifferentiated class of discriminating consumers. The difficulty with this claim is that the characterization does not correspond to the empirical facts.

As a preliminary step to understanding the states' rapid movement to enact LLC states, we survey the influence of special interests that shaped the pattern of legislation. Having surveyed some of the potential class of objectors as well

as interests in support of the legislation, we look at the role of business lawyers in the enactment process. They have a high-powered incentive to persuade the legislature to enact the LLC statute in order to increase fee revenue. There appears to be a one-period pent-up demand that lawyers can satisfy stemming from the existing inventory of partnerships, limited partnerships, and corporations that will opt to transfer to the LLC status. The desire for incomes extends into the subsequent period when lawyers presumably gain to the extent that new firms that otherwise would organize as partnerships choose the more formal and expensive LLC form and also benefit to the extent of new capital formation. To be sure, lawyers will lose to the extent that firms that otherwise would organize as more expensive corporations or limited partnerships select the LLC form. Thus, lawyers will have little problem in mobilizing to procure the legislation and their bar associations will routinely step in to solve problems of collective action respecting enactment of beneficial legislation, serving the drafting functions as well as the lobbying functions. Conversely, the projection of income reduction to plaintiff's lawyers stemming from the difficulty of collecting judgments against LLC's amount to a distant period problem which could discount the number of lawyers in favor of prompt enactment of the legislation.

Based on the survey of competing interests, we offer a 'just so' story of the speedy enactment of an LLC statute. By this I mean, the historical proliferation of LLC legislation has been attributed to the initiative of state bar committees rather than to the initiatives of legislators themselves. State treasurers, even if they have objected, were overruled. The banks and the plaintiffs bars appear to have taken no interest in the matter. Thus, in practice, the business lawyers' high-powered incentives appear to have carried the day. Here, the supply-side interest procure the legislation in the usual manner of interest group capture and the demand being satisfied stems in part from a perverse incentive to externalize accident costs. We should like to note that, given the incentives, the innovations respect the LLC statute will continue in the successive periods. As the practitioners learn the defects of the statute they are likely to demand revisions to the law in order to satisfy client demand for lowest possible organization costs. The 'just so' story explains the rapid evolution of the prevailing forms of the LLC statutes.

I shall not say much about whether regulatory competition can be accorded a primary place in an explanation of the proliferation of the LLC statute. In terms of whether there will be a race to the bottom, there is no per se evidence to suggest that the intense competition between the states leads to a prisoner's dilemma. It is more likely that wider the spread between the benefits and costs of liability in each state, the more probable it is that a given state will have

an incentive to move to a limited liability regime. Given such a first move, a race to the bottom among the remaining states in a federation may or may not ensue, depending on the cost-benefit posture of each state. We should note that the presence of out-of-state alternatives does not by themselves dictate the conclusion that a particular body of law relates from the competitive disposition of the legislature. In a world of interest group politics, competitive incentives on lawmakers' part cannot be assumed. In describing the diffusion process of competitive lawmaking against the background of interstate movement of factors of production, we conclude that it is necessary to describe the incentives must be described with particularity before a finding can be made as to whether regulatory competition or anything is responsible for the proliferation of LLC statutes.

1.4 Creative Lawyering and the Production of Regulation

It follows from what I said in the previous section about lawyers that in some cases, the origin of particular legislation or regulation may be significantly influenced by the bar and individual legal professionals. It is the presence of significant supply-side incentives (i.e., fees and reputation) which stimulates lawyers to invest heavily in the lawmaking process. Chapter 7 offers an example of this perspective in the context of US legislation on the development of insider trading regulation.

1.4.1 Bourdieu and Legal Autonomy

A rich literature has developed around the nature and process of lawyering itself. The sociology of the professions perspective has been extended by a sophisticated post-structuralist perspective set forth in the work of Pierre Bourdieu (1987). This theory has focused on the competition between lawyers, where the struggle among lawyers to distinguish themselves has resulted in the production of an autonomous legal system. The idea of legal autonomy is not itself a novel creation of Bourdieu. Rather, the fundamental insight of Bourdieu is that the legal system, while it possesses its own abstract and formal nature, guaranteed by legal norms and doctrines, does not possess the principles of its own dynamic. The legal field is constructed by reference to the strategic behavior of the professionals, and the operation of the legal institutions. Bourdieu's view of the legal system is supplemented with a theory regarding how the indeterminacy of legal rules enable the various groups of competing legal professionals to use their respective resources and techniques to generate alternative rules, which can be deployed to support the contrasting strategies of organized groups within society. Hence legal professionals perform the function as mediators between the realm of formal law and the economic and

social practices of their clients. This approach offers another way of thinking about the dynamics of regulation.

The basic model of the theory of professional conflict, as applied to regulation, begins with the observation that the indeterminacy of legal rules is functional since it provides the flexibility and adaptability. It is assumed that the lawyer, who possesses high-powered incentives, can be expected to pressure for changes in the patterns of behavior by creating a new rule or norm. As we have seen in the context of the LLCs, the most influential supporters of new innovations in the law were the corporate lawyers who have moved first by undertaking to invest in local corporate law reform. Yet, not all lawyers will support investment in legal innovation on an ongoing basis. For example, in the case of corporate law changes, local firms will tend to free ride on legal research provided by national committees unless an investment in a local code has obvious rent implications.

From this perspective, it is legal professionals who may set in motion the dynamic of regulatory change. If regulation is approached from a norm entrepreneurship approach, this in turn implies that analysis can not be confined to the study of legal professionals employed in private firms. This is the traditional approach taken in the sociology of the professions literature. The process of regulatory innovation must be situated in a wider context. Chapter 7 seeks to examine the relationship between the process of regulation and the competitive process between government and securities lawyers over the establishment of a new norm concerning the opportunity to use undisclosed material information for securities trading. Until the 1980s there were few cases brought against insiders trading on non-public information. Throughout the 1980s, government lawyers, through a series of high profile cases, attempted to aggressively extend the rule against insider trading to a significant range of trades. Despite judicial ambiguity concerning the misappropriation theory, government lawyers, with the tactical backing of certain sectors within the securities industry, were successful in their efforts to establish a clear standard against the use of non-public information in securities trading. As is further argued in chapter 7, this process of legal innovation may also be the product of the changes in regulatory structure brought about by Congress. As we shall see in the next chapter, it is inevitable that the challenges to the pre-existing patterns of regulation of insiders is assumed to be the work of private interest groups which influenced the politicians to enact new legislation. Yet, the content of regulatory change, as I will show in chapter 8, is also affected by the behavior of opportunistic public officials and the institutional arrangements for administering regulatory policy.

1.4.2 Interest Intermediation and the Supply of Regulation

The following discussion anticipates that of chapters 8, which provides a fuller exposition of the public choice perspective to regulation of a legal field. This chapter is concerned not so much with the instruments of regulatory policy but with an approach to policy which takes account of the features of interest groups, regulators, and politicians when explaining the emergence and implementation of regulation. Here I shall consider the perspectives of demand-based models of lawmaking, and contrast that approach with additional body of literature, the supply-side story. The supply-side approach focuses on legislators as suppliers of regulation. The incorporation of the supply-side dimension introduces a number of features of political structures which has the potential to explain lawmakers' responses to demand pressures.

Analyses of regulation that are based on public choice theory make intensive use of abstract models that describe the strategic interaction between the key private actors and government regulators (Peltzman 1976). This approach, conceived in terms of an efficient competitive political process, reflecting the diverse and contrasting preferences of the private actors and regulators, concentrates exclusively on the competition between the private interest groups. This simple demand model of capture asserts that lawmaking follows the lawmakers' response to demand patterns (Tollison 1988). Particular responses depend on interactions between the lawmakers' risk profiles and the projected benefits of legislative action (Becker 1983). The lawmaker, being risk averse, tries to avoid conflicts — given no demand for legislation, nothing is done; given organized demand, the lawmaker attempts to satisfy the interest group making the demand with beneficial legislation.

An additional body of public choice theory supplements this demand model with a supply-side story. Exclusively demand-based models of law production tend to treat the political process as a black box and, as a result, do not attempt to describe how legislative trades are accomplished and enforced (Weingast and Marshall 1988). This is a problem, since legislative trades, unlike well-drafted private contracts, can be undone at the subsequent behest of a competing group. Supply-side explanations of interest-group dealmaking confront this problem of political insecurity by drawing on the organizational economics to show that institutional arrangements have an impact on outcomes. This body of work disaggregates the government into a complex of principal-agent relationships (Macey 1992). In these stories, legislatures develop process and structure machinery to control the opportunistic conduct of both career bureaucrats and legislators (Baron and Ferejohn 1986). These devices include the legislative committee system, which helps to overcome problems of asymmetric

information between legislative principals and bureaucrats through *ex post* monitoring, and process requirements for rulemaking, which provide advance notice of noncomplying conduct. The processes of the legislature also contribute to transactional stability: Legislative procedures and committee jurisdictions give the congressional gatekeeper the ability to resist short-term internal pressures (Shepsle 1992).

Chapter 8 draws some lessons from the supply-side approach to retell the regulation of insider trading story. Many discussions of the proliferation of insider trading laws attempt to explain it fully in terms of the need for worldwide uniformity of regulation. This chapter seeks to consider the context in which there has been a sustained demand for insider trading regulation. I show that the demand stems from the changes in the competitive environment of international securities trading which led to a new environment in which banks and financial firms operate. Tighter trading margins and stepped-up competition have led market makers and institutional investors to square off against corporate insiders, whose activities were proving increasingly costly to the former. It is argued that Congress saw potential benefits in supply new rules, given constituent demands and the state of public opinion in the face of market scandals. Supported by Congress, the Securities and Exchange Commission (SEC) in turn proposed increased enforcement in exchange for increased budgets and powers. Yet, the SEC was able to manipulate the situation by providing a framework of rules and enforcement procedures which were sufficiently ambiguous to satisfy its own heterogeneous constituents: market makers demanding change, corporate insiders who were targeted by the new regime, and incumbent corporate managers who wished to limit the power of market makers in takeover battles. Throughout this chapter I assess the implications of the SEC's attempt to develop regulatory strategies which expand its influence and enforcement powers. In this context, I outline the SEC's attempt to develop international regulatory strategies, based on reciprocity and harmonization, with foreign regulators. Despite the apparent convergence around US style norms against insider trading among EC member states, I attempt to show that the prevalence of highly differentiated enforcement standards tends to reflect the contrasting nature of interest group participation in the process of government intervention of the securities industry in each country.

1.4.3 Policy Choice and Democratic Decisionmaking

As indicated earlier, much of the political economy of regulation approach has been developed to understand how the choice of policy is influenced by distributional influences on both the supply and demand considerations. In this regard, the theory is normative since it is concerned with the design of regula-

tory policies which can limit opportunistic behavior and hence provide greater long-term benefits for groups making investments. In chapters 9 and 10, I extend the insight of political economy model to explore decisionmaking in fields of public law and constitutionalism.

In public law and constitutional theory, there is an influential perspective that purports to offer an account about how political institutions develop. The rational choice paradigm relies on an instrumentalist account of preferences to show how the conflicts over political choices can lead to coordination problems. As we have seen earlier with market contractarianism, the rational choice proponents argue that political institutions evolve to equilibrium based on the optimal selection of social choice rules. The theory, derived from earlier work of Hobbes, Rousseau, and Kant, attempts to determine the goods which could be secured by people based on rational agreement. It asserts furthermore that the terms of agreement (i.e., principles of justice) serve as the neutral standpoint for assessing social structures. Ironically, proponents argue that the principles of justice, despite the lack of actual bargaining, are the product of a bargain between the parties in an original choice situation.

In chapter 9, I focus on the English public law arguments relying on contractarian arguments as a basis for democratic legitimation. There I show that modern constitutionalism, in contrast to the contractarian story, is based on a set of political and legal structures which provide a standpoint to launder the preferences of diverse interest groups. Chapter 10 examines contractarian theory in terms of the instabilities created by ethnic conflict, redistributive policies, and other deep cleavages in society can be accommodated by the traditional range of democratic mechanisms. I argue there that the contractarian approach suffers in that it relies on a single mechanism (eg., the hypothetical contract) for the evaluation of democratic institutions. The theme of these chapters is to offer a political economy perspective concerning the design and implementation of democratic arrangements which take into account the diverse individuals and bargaining processes.

1.5 Conclusion

The political economy perspective introduces a powerful new way to evaluate the structures of political and regulatory institutions that have, until recently, survived critical examination. It is hoped that these chapters provide a foundation for further development of the second-best framework.

CHAPTER 2

RISK, TRUST, AND THE MARKET FOR CORPORATE CONTROL¹

2.1 Introduction

In the 1980s the American corporate economy experienced a massive increase in liquidity. This increase was linked to two sources: (1) an increase in internally generated funds within firms which were employed for the purposes of strategic acquisitions; and (2) the introduction of high-yield bonds which made possible the acquisitions of large corporations by relatively small firms or groups of investors (Jensen 1987). As a result of this massive increase in liquidity, there was a huge wave of hostile take-overs (Jarrell et al 1988). The emergence of a 'self-regulating' market for corporate control redefined the traditional relationships among shareholders, managers, and non-equity stakeholders.

Business scholars, lawyers, and economists alike argue that the market for corporate control fundamentally changed the legal and corporate landscape in the United States and, to a certain extent, Britain in the 1980s (J. Gordon 1991; Coffee 1991; Jensen 1987; Coffee 1987; Chiplin and Wright 1987). In support of this proposition, evidence is offered regarding the scale, intensity, and efficiency gains of the merger activity. For example, Jensen observes that during the mid to latter half of the 1980s, corporate control transactions exceeded the 100 billion dollar mark each year (Jensen 1987: 314). These take-overs were dominated by a particular driving force: the desire to bust up the conglomerates formed during the merger wave of the 1960s and 1970s, which contributed to the furious pace of the market activity in the mid-1980s.² The

¹ This chapter appeared in J. Mc Cahery et al (eds.), *Corporate Control and Accountability* (Oxford: Clarendon 1993).

² During the 1960s and 1970s most mergers were conglomerate, not horizontal (Scherer 1986). It is well documented that the conglomerate strategy was a dismal failure: '[L]arge scale movement of U.S. manufacturing toward unrelated diversification is now thought by

conglomerate structure was an attractive target because it was easier to value (J. Gordon 1990).³ However, there were only a small number of conglomerates which were actually dismantled and whose assets were spun off to their most valued user (Gilson and Kraakman 1991); furthermore, directors and managers themselves, in response to the stock-market's judgment that the conglomerate merger wave of the 1960s was, in effect, an economic mistake (*ibid.*), restructured their asset portfolios by spinning off unrelated divisions which were obtained during the conglomerate acquisition phase. There is evidence to suggest that managements' motive for restructuring the corporate asset and ownership structure reflects their desire further to entrench themselves, by improving their bargaining position, at shareholders' expense (Dann and DeAngelo 1988).

The changes involved in these transactions have been the subject of intense debate (see generally Bhagat et al. 1990; A. Auerbach 1988). Economists have attempted to determine whether take-over activity promotes economic efficiency or not (Franks et al. 1991). More specifically, some economists have attempted, with varying degrees of rigour and success, to measure the relative efficiency of take-overs as a means for redeploying assets. Indeed, one school of thought, heavily identified with the liberal wing of the Democratic Party in the USA, argues that take-over activity damages the productivity of firms, causing managers to plan for the short term, resulting in a reduction of expensive (but necessary) investment in human capital, R & D, and fixed capital and a long-run decline in economic productivity (see, e.g., Shleifer and Summers 1988; Shleifer and Vishny 1988).⁴ These critics argue that proponents of the

many observers (including Porter) to have been unsuccessful. The high level of divestiture of peripheral businesses by diversified corporations beginning in the mid-1970s is almost surely a response to that failure' (Shleifer and Vishny 1988: 13).

³ To be sure, there were other considerations behind these acquisitions-tax gains, management entrenchment, strategic investments, etc.-although the dominant consensus is that the 1980s movement was motivated by the liquidation value of the target's assets. Certain commentators note, however, that the 1980s take-over movement was primarily motivated by firms acquiring businesses with similar assets. On this view, corporate managers, despite the threats of take-over and other disciplinary and market pressures, invested firm resources, even if they were not *ex ante* value-maximizing, in order further to entrench their firm-specific investments (Shleifer and Vishny 1989:126). Also, a study by Bhagat et al. (1990) of 62 hostile take-overs between 1984 and 1986, in which the price paid or offered was higher than \$50 million, shows that while tax savings, lay-offs, and strategic investment cuts were important reasons for the efficiency improvements in the post-take-over experience, 60% of the efficiency gains, according to the authors, came from transferring the target's assets to their most valued use.

⁴ Coffee (1984: 1148 n. 5) summarizes dissenting views; see also (Tirole 1988: 43-4).

market for corporate control rely on an especially narrow conception of efficiency,⁵ limited to notions of improvements in management or gains from organizational synergy. Herman and Lowenstein (1987), for example, argue that acquisitions motivated by the undervalued market values of the firms do not function solely to remove inefficient managements or to improve the deployment of assets, but rather reflect an operational flaw in the share market and its valuation process. Furthermore, these critics argue that the initial vision of the control market (offered by Manne 1965), which characterized the control market in terms of competing managers attempting to acquire assets in order to put them to their most efficient use, has been fundamentally reoriented by several factors, essentially by the competitive nature of the market and the attraction of premium short-term earnings.

Shleifer and Vishny (1988), for example, have endorsed the externalities perspective, arguing that most transactions have both winners (shareholders of the target, raider, etc.) and losers (non-management constituencies such as employees, suppliers, communities, and creditors). In the wake of the hostile take-over, they argue that acquiring shareholders appropriate stakeholders' ex post rents in the implicit contracts, which accounts for the efficiency gains.⁶ They argue that the existing efficiency studies on take-overs are theoretically suspect, because they evaluate the wealth effects solely in terms of shareholder wealth. Embracing the property rights view of the firm (which conceives of

Take-overs, according to Tirole, often produce perverse incentives for managers, and as a result are inefficient, e.g., the existence of the threat of take-over reduces a manager's incentive to make long-term investments, since she will not have an opportunity to capture her future rents. Moreover, the increased risk injects a new level of insecurity into the firm for junior and senior management. In response, managers disinvest in firm-specific assets, and are over-concerned about their career prospects, which may lead them to make decisions which are contrary to the interests of the residual risk-bearer. Finally, because the relationship between worker and manager may be short, the element of trust may not develop between them.

⁵ E.g., L. Summers (1990) argues that the reallocation of assets, which he speculates must logically involve the transfer of earnings from where they carry a low price/earnings ratio to where they carry a high ratio, must result in increased value only for those agents involved in the transactions. He cautions that the alleged efficiency gains which occurred as a result of take-over activity in the 1980s should be set against the background of a share market which tripled. Summers argues that the real source of value may be traceable to the ability of the acquirers to obtain reasonably cheap sources of financing for purchase of the stocks at an attractive rate. However, it is not at all clear that the value captured in such take-overs derives from efficiency gains, since other sources of value (e.g., lost tax revenue or undervalued human resources) may be very high, and dwarf the efficiency effects.

⁶ This argument has also been advanced by Shleifer and Summers (1988). For critical accounts of the logic of this claim, see Holmstrom (1988) and Williamson (1988b).

the firm in terms of a set of ex ante incomplete contracts, in which the ownership of the asset confers certain ex post rights, which affect the bargaining power of the players and the ex post distribution of the organization's quasi-rent),⁷ Shleifer and Vishny go on to argue that shareholders, when making a hostile purchase of an asset, are not in fact acquiring the rights to maximum feasible profits, but rather, are obtaining control over an asset which cannot assure them a satisfactory return on their investment.

Other theorists, by contrast, argue that take-overs improve the overall productivity of the economy. Proponents of the market for corporate control offer diverse reasons for the efficiency gains that result from hostile take-overs. For example, Jarrell et al (1988) argue that shareholders of target companies clearly gain significant wealth. In particular, some empirical work suggests that the source of value in hostile take-overs is not traceable to the stock-market underpricing of stock or short-term myopia (J.C. Stein 1988). Furthermore, empirical evidence shows that labour cost saving following hostile take-overs is a marginal component of the apparent wealth gains from take-overs.⁸ There is considerable controversy over the tax gains in take-overs. However, the view that tax gains are embodied as trapped equity has attracted few new proponents since recent share repurchase data failed to confirm the tax gains hypothesis (J. Gordon 1990). Commentators generally agree that the major source of value results from the reallocation of assets following the completion of the take-over (see, e.g., Bhagat et al 1990: 34-44; Jarrell et al 1988: 57-8). Furthermore, the evidence of the 1980s seems to show that friendly take-overs largely function in order to reallocate assets to firms operating in related businesses. The value gains from these strategic acquisitions may result from efficiency gains in production and distribution, as well as from other gains such as white collar lay-offs, tax savings, and R&D cutbacks (Jarrell et al 1988: 57).

Against this background, the efficiency consequences resulting from these transactions are directly realized by the wealth transfers to the shareholders. The external costs appear to be low compared to the efficiency gains. L.

⁷ The property rights theory of the firm has been developed in Grossman and Hart (1986); O. Hart and Holmstrom (1986); Tirole (1988); O. Hart (1989); Milgrom and Roberts (1990); Kreps (1990); Holmstrom and Milgrom (1991). For a critical appreciation of the property rights standpoint, see Holmstrom and Tirole (1989) and Williamson (1990, 1991h).

⁸ See Bhagat et al. (1990: 52-4) arguing that savings are especially important in the case of leveraged buy-outs (LBOs) and management buy-outs (MBOs), Gilson et al. (1987); A. Auerbach and Reishus 1988 (dismissing the role of taxes as a source of value based on the tax procedure of combining losses with profits). But see L. Summers (1990) (rejecting Auerbach and Reishus's investigation, since everyone agrees that the ability to combine losses with profits is insignificant).

Summers (1990), however, suspects that a closer empirical investigation might reveal that the efficiency gains obtained from horizontal acquisitions, which were the main type of transaction in the 1980s, are more closely tied to other sources of value, which would mean higher external costs.⁹ Furthermore, it is difficult to ascertain whether the post-merger efficiencies are the result of increased market concentration and market power or the result of lower transaction costs. Theorists on both sides of the divide concede, however, that the strategic combinations of the 1980s resulted in abnormal increases in stock-market prices, which indicates that there was a source of value created. Central to my discussion is the claim made by proponents of the implicit contracts theory that take-overs are motivated by the wealth gains from breaching implicit contracts. In particular, Coffee argues that much of the shareholders' wealth gains are the result of the rents captured from stakeholders (Coffee 1987: 111; see also Shleifer and Summers 1988: 42-3; but see Holmstrom 1988: 57-8).

The debate among economists is concerned with the existence, size, and location of the wealth gains. My focus in this chapter concerns the related, but rather different, legal issues: specifically, the strategic relationship between managers and shareholders in the firm and how the 1980s market changed that conflict.

Hence, I wish to consider the primary justification for the market for corporate control: the market as an effective check on managerial discretion. In section 2.2, I examine the historical dimension of the debate, concentrating on the managerial theorists and their explanation of why managers prefer to satisfice rather than maximize profits. In the next section, I link the discussion of managerial theories with Coffee's differential risk hypothesis. Coffee's theory is analyzed in detail, since it constitutes the controversial claim for the 1980s hostile take-over movement that the asymmetry of risk between manager and shareholder explain the rapid changes in the market for corporate control. I attempt to show that Coffee's model of risk asymmetry provides only a partial explanation of the 1980s merger movement. I argue that the conflict between manager and shareholders is an unsteady game, which depends on risk, resources, and time, and that the competition for control over the firm is dependent upon the outcomes of this continuous struggle, which often involves political lobbying by threatened managers to protect their firm-specific capital from expropriation (Romano 1990). Critical discussion of the differential risk model is particularly relevant to recent debates regarding the impact

⁹ Certain theorists have argued that the value gains from hostile take-overs might reflect a market overestimation of the value of the strategic acquisitions, and therefore the level of gains could be questionable (Bhagat, et al. 1990: 57-8).

and justification of statutes protecting stakeholders who are not equity participants in the firm (Coffee 1990; Rock 1992). The new normative vision of corporate control challenges the shareholder maximization norm by emphasizing the legally enforceable obligations of stakeholders. The articulated political logic of the stakeholder coalition model is qualified and supported by the device of the implicit contract (Rock 1992: 545-8).

2.2 The Historical Antecedents

In this section I survey the development of the modern firm. This is a well-travelled path (Bratton 1989b). The aim of this discussion is to demonstrate that the problem of control within the firm is long-standing and is connected with the modern changes in the internal organization of the firm.

The early development of corporate theory was concerned with the question of how to resolve the alleged problems which occur as a result of the separation of ownership and control of the firm. The consolidation of the corporate firm in the 1920s, and the survival of such firms following the crash and the great depression, was the historical background against which the emergence of managerialist theories of the firm can be understood. In the United States, the growth of the firm was facilitated by the departure from the unanimous shareholder approval rule, which introduced the flexibility necessary for management to consolidate small firms into large, multi-divisional ('M-firm') companies (Note 1989a: 824). The rapid growth in firm size was accomplished principally through public issuance of shares which, over time, further diminished the leverage of shareholders to alter management's power within the firm. As a result, the changing position of the shareholder altered the legal theory of the corporation, giving management enhanced control and relative independence from individual shareholders.¹⁰

The growing importance of the firm, the increasing dominance of managers and the passivity of shareholders, and the failure of neo-classical theory to

¹⁰ Dan-Cohen (1986) provides support for this account. He states that research conducted since Berle and Means's classic study 'confirms the radical separation of stock ownership from control in the large corporations which these authors have emphasized' (Dan-Cohen 1986: 18 n. 20; see also Blumberg 1975). Moreover, Dan-Cohen notes that, along with the decline in the classical picture of the corporation, there has been a dramatic decline in the significance of the individual shareholder. The extant empirical studies indicate that, historically, investment funds available to corporations were generated either from a firm's internal free cash flow or by institutional investors. Thus, the historical insight which follows is twofold: first, the splitting of the ownership atom provides a degree of autonomy from the individual shareholder; and secondly, the individual shareholder is no longer anchored to a single firm, but rather is spread across many firms.

explain the development of the firm formed the practical and conceptual background against which Berle and Means wrote *The Modern Corporation and Private Property*. In their classic work, they observed that shareholders were effectively powerless to exercise control over the firm, because ownership was so dispersed and because the residual risk-bearers were, in effect, incapable of co-ordinated action against incumbent management.¹¹ The decline of the single-owner firm, as the story goes, dissolved the significance of the individual entrepreneur as both residual risk-bearer and manager. Thus, with the 'splitting of the ownership atom', the professional manager commanded greater control over the firm's resources (Coleman 1990: 457).

Due to the change in investment patterns, Berle and Means suggested that there is a problem of corporate control.¹² Recently, Bratton (1989b:191-4) has interpreted the Berle and Means thesis as offering a combined institutional and contractual mechanism for confronting the problem of the fractured ownership structure. For Berle and Means, management is responsible for deployment of the firm-specific factors of production, whereas shareholders functioned as residual risk-bearers and suppliers of equity. In turn, the share market functions as the institution of mediation between management and shareholder, providing both monitoring services and exit for any discouraged shareholders. Hence, the corporation is conceived as a bureaucratically con-

¹¹ Berle and Means detected that shareholders have a collective action problem. The dispersion of shareholders leads to rational apathy, in which each shareholder has a preference, in the absence of incentives, to avoid the costs of monitoring management. There can be little doubt that by the 1920s and 1930s management and shareholders had reached an implicit agreement that managers would 'maintain stable dividends in return for the freedom to pursue a "growth" strategy' (Bratton 1989b: 1492-3). Bratton argues that this agreement permitted managers to raise capital internally, and thereby avoid market review of their performance.

¹² Williamson (1971: 346) notes that the corporate control issues which Berle and Means pointed to have been alleviated as a consequence of the changes in organizational structure of the firm. In particular, Williamson (1983: 3601) argues that most large firms in 1932 were large functionally organized (U-form) business firms. The expansion of U-form firms '(1) results in greater control-loss experience, and (2) the utility function of the firm is augmented to include the expense-preference inclinations of the functional divisions'. Williamson argues that the reshaping of the U-form firm into a divisionalized (M-form) firm, in which strategic and operating purposes were separated, significantly reduced the inefficiency in information, and reduced the opportunism of management, by introducing a firm-wide competition for resources which, at the same time, facilitated the selection of investments that created greater returns to residual risk-bearers. However, Coffee challenges Williamson's explanation for the M-form on the grounds that the development of the conglomerate had more to do with management's preference for growth than with the lowering of transaction costs (Coffee 1987: 89).

trolled organization which is tied essentially by contract to shareholders via the securities market. Bratton argues, however, that the contract is implicit, since there is no effective means of enforcement. Thus, Berle and Means set forth the fundamental premise of managerialism: the growing separation of ownership and control of the corporation displaces the owner-entrepreneur from the helm of the firm, which is now taken by the manager.¹³ The separation of functions has created a series of potential conflicts within the firm (Coleman 1990: 456-65).

2.2.1 Origins of Corporate Control

Following Henry Manne's (1965) paper 'Mergers and the Market for Corporate Control', the study of the market for corporate control officially began. Manne articulated a powerful challenge to the conventional 'managerialist' approach to the study of merger activity, which understood merger activity in terms of increased managerial power, by stating the simple proposition that the corporate merger might serve to discipline management discretion. Following Berle and Means's (1932) explanation that the firm is characterized by the separation of ownership and control, Manne argued that the disciplining of inefficient management is best handled by an outside take-over by shareholders; hence, the stock-market operates as an external monitor of management, in that the share value of the firm reflects the relative efficiency of the management. Thus, the market for corporate control operates to discipline

¹³ Coffee (1987: 81) observes that nearly everyone who has written on the firm since the 1930s has employed Berle and Means as a conceptual springboard to introduce the modern picture of the firm. He notes, however, that most writers depart from the Berle and Means characterization of managers as potentially autonomous. In effect, the vision of the firm offered by Berle and Means is a gross exaggeration of reality, since the separation of ownership and control did not entirely release managers from activity in the interest of the residual risk-bearer. Coffee certainly argues persuasively that managers over time have rationally chosen less autonomy (in the form of bonding and monitoring devices) in order to increase the value of the firm. Generally, he is claiming that shareholders rationally rely on managers to offer guarantees in order to attract external capital, since the economic welfare of managers depends on their ability to attract future shareholders. The second point of departure from the Berle and Means thesis, and one endorsed by Coffee (1990), is that the image of the shareholder as owner of the firm should be replaced by a conception of the firm understood in terms of an equilibrium position achieved through successive rounds of strategic bargaining between shareholders, creditors, and managers. Coffee's theory of the firm, which will be explored in some detail later, operates within the orbit of the managerial game-theoretic conception developed by Aoki. Like Aoki (1988), Coffee emphasizes the importance of ex ante relative bargaining power in the ex post distribution of the residual.

managements which fail to act in the interests of shareholders. Managers who do not reduce the agency costs to shareholders are subject to the threat of take-over, which clears the way for more responsive managers to organize better returns for investors.

Yet Manne's neo-classical approach to the shareholder-manager conflict was not the dominant explanation for merger activity in the 1960s and 1970s. Rather, as Bratton has noted, the managerialist interpretation was the dominant theory of merger activity during that period. Seeing management as being at the helm of the firm, managerialists argued that, by virtue of their expertise in decision making and control over the firm's information rents, managers possessed considerable discretion. The managerialist view was premised on certain behavioural assumptions. H. A. Simon (1955), for example, argued that managers operated in a world of bounded rationality, and, as a result, managers satisfied rather than profit-maximized. On this view, because the external constraints on managers are weak, shareholders' return to capital is necessarily sub Pareto-efficient. Thus, the separation of ownership and risk-bearing functions provides the space for managers to design strategies which work against the welfare interests of the residual risk-bearer.

The Berle and Means thesis also provided the basis for the more developed managerial theories of the firm of the 1950s and 1960s, which attempted to explain the workings of the management controlled organization on the basis of various hypotheses. The managerial discretion hypothesis essentially holds that the profit motive does not explain the structure, organization, or performance characteristics of management (Aoki 1984: 35). Instead, it is argued that managers maximize their own interests, based on the pursuit of power, prestige, and higher remuneration associated with the growth of the firm. The managerial utility hypothesis assumes that management is resourceful and capable of using its position within the firm to grab a significant portion of the firm's rent.¹⁴ Early theorists of the firm, for example Baumol and Williamson, observed that management had only a minimal constraint on its opportunistic use of the firm's capital. In fact, Marris offered perhaps the most interesting analysis of the managerial utility function, stating that managers used their power to expand the firm beyond the size which maximizes share-

¹⁴ Dennis Mueller notes that since profits are to some degree the property of the residual risk-bearers, managers are forced to grab the firm's residual funds in a manner that appears from the outside to be a legitimate transaction cost. Thus, because there are few ways legitimately to absorb pecuniary funds, Mueller contends that managers most often take residual profits in a non-pecuniary form (D. Mueller 1986: 44). In order to maximize their managerial utility function, Mueller claims that managers will, in the context of uncertainty, seek to acquire information so as to increase the probability of their obtaining their personal pecuniary and non-pecuniary objectives.

holders' wealth. On this theory, managers deploy the firm's free cash flow to expand the growth of the firm, and lessen the degree of managerial insecurity within the firm.

Marris was the first to claim that managers' security-seeking behaviour is constrained by the threat of hostile take-over (Aoki 1984: 39). The work of Marris and the economic managerialists can best be understood in terms of managers attempting to diversify their portfolio within the firm (Coffee 1987: 81). Thus, a growth policy pursued by senior managers (and supported by junior executives) is a rational strategy if and only if, it succeeds in reducing psychic tension and the personal risk of their firm-specific investments (Aoki 1984: 41). Marris argued that the threat of take-over was the best constraint on manager's pursuit of their growth policies. However, he stated that the market for corporate control was not fully constraining, because the take-over threat did not threaten all goals such as growth which were favoured by incumbent managers. Because of market and organizational failure, Marris argued that the modern firm tends to deviate from the model profit-maximizing firm.¹⁵ Marris's managerial growth model was heavily criticized by Solow (1971) as being indistinguishable from value-maximizing models, because firms with different goals will respond in precisely the same manner to changes in data; i.e., tax rates, interest rates, wages, and firm subsidies. This criticism, while analytically telling, misses the most crucial insight provided by the model: namely, that managers of large corporations prefer growth over profitability, and that this preference is evidenced in the expenditures directed toward mergers (Shleifer and Vishny 1989; P. Auerbach 1988: 122; Williamson 1987b: 160).

2.2.2 The New Management Environment Thesis

How insightful is Marris's model today? Coffee (1987: 88), for example, has recently argued that despite the model's dated theoretical assumptions (that firms are static structures and that the external constraints on managers are weak), Marris accurately described managers' preference for growth over short-run maximized profits of the firm. In support of this proposition, Coffee argues that the recent trend toward the bust-up take-over in the late 1980s is

¹⁵ Marris and Mueller (1980) argue that Marris's original thesis, that there is 'considerable slack in the take-over mechanism', has been confirmed by all available empirical studies conducted up to the time they drafted the article. Based on pre-1980s take-over data, they argue that the market for corporate control has failed to drive out non-shareholder welfare-maximizing behaviour and the opposite result has been instantiated (Marris and Mueller 1980: 44). This argument has been endorsed from a slightly different vantage-point by Shleifer and Vishny (1988).

ironically telling evidence in support of the managerial growth hypothesis. Coffee speculates that the reasons for the bust-up trend are connected to the fact that firms in the 1960s and 1970s had grown to a sub-optimal size, or that managers failed to pay out more of the residual cash flow to shareholders in the form of dividends.¹⁶ By contrast, he offers a more subtle and original interpretation for the 1980s era of bust-up mergers. He argues (Coffee 1987: 78) that the emergence of the hostile take-over in the 1980s '[a]ltered the character of the American corporation, both in terms of its goals, span of operations, and the behaviour of its managers and in terms of its ability to compete with foreign rivals'.¹⁷ In particular, he argues that the 1980s movement constituted a return 'to the apocryphal era that Berle and Means assumed once existed where managers were in fact dutiful agents to shareholders' (Coffee 1987: 83).

Coffee's argument proceeds on two analytically related levels. First, he suggests, following Jensen and Williamson, that the central legal conflicts between shareholders and managers have been resolved by a series of bargained compromises which obviate the concerns expressed by Berle and Means.¹⁸ Secondly, Coffee argues that the central conflict between managers

¹⁶ To a certain extent Coffee relies on Jensen and Meckling's (1976) thesis in support of this observation. Unlike property rights theorists, who attach theoretical significance to the distribution of resources in calculating the costs of co-operation between owners of property rights, Jensen and Meckling are concerned with how to align principal and agent interests. For them, agency costs are inevitable, since contracts are not costlessly written or enforced. Against this background, the rational interest of the agent is to reassure investors that the firm has an institutional structure which reduces agency costs, since their information rents depend on future shareholder support. The market for corporate control operates to reduce agency costs. The threat of take-over is thought to be sufficient to overcome an agent's shirking tendencies. More recently, Jensen has argued that the central conflict between principal and agent is over the firm's free cash flow: managers tend to retain the free cash flow for their own use, and shareholders attempt to get management to disgorge the capital as dividend, and this conflict partially explains the recent trend in hostile take-over activity (Jensen 1987: 314).

¹⁷ A recent empirical study, however, indicates that hostile take-overs do not significantly restructure the firm (Bhagat et al. 1990: 57).

¹⁸ The proposition that most legal conflicts between shareholder and manager have been resolved is not entirely persuasive. Let us consider the assumptions Coffee makes. Like transaction cost and property rights theorists, he assumes that certain terms of the employment contract between managers and shareholders are incomplete. Coffee stresses that if parties find it in their interest to agree, given imperfect knowledge of the gains from strategic behaviour and the ex post costs of negotiations, they will be disposed to cooperate. However, this cooperative game framework is limited, since a player's normative assumptions about strategic costs will affect that player's normative position with respect to

and shareholders concerns the degree of leverage or risk in the firm.¹⁹ Coffee makes a major contribution to the theory of the firm by showing how the concern for risk is central to both managerial and nexus-of-contracts theories²⁰ and by connecting this problem to the larger areas of conflict in society regarding the debate over socially acceptable levels of risk.²¹

2.3 Risk and the Firm

In this section I will begin by analysing Coffee's risk aversion model, so as to develop some general points about the bargaining problem between managers and shareholders.

It was the higher level of risk created by the junk bond funding of hostile

a parties disposition to co-operate (Katz 1990; see also Elster 1989).

¹⁹ Unlike contractarians who are concerned only with welfare, Coffee (1987: 113-14) directs his analysis to the distinctively normative question of whether the law should encourage wealth transfers from non-shareholder to shareholder classes. His concern is normative, because he is guided by the fairness of the actions of shareholders and the relative positions of the parties. To be sure, Coffee, like contractarian theorists, is not anxious to craft public policy interventions that sub-optimally redistribute assets. Rather, his justification for addressing the conflict in the first place is to offer a structure whereby the parties might design welfare-maximizing private agreements.

²⁰ The corporate law world is dominated by the nexus-of contracts view of the firm. More a metaphor than a theory (Bratton 1989c), it has become almost mandatory to refer to the corporation as a nexus of contracts, which involves treating the firm as a legal fiction. The strength of this approach is that it brings into focus the fact that the firm is constituted by a series of contractual relations between employees, managers, suppliers, creditors, shareholders, and bondholders (Jensen and Meckling 1976). This approach has recently come under attack from a variety of perspectives. Property rights theorists, e.g., argue that the nexus-of contracts perspective does not explain the firm, but, rather, 'leaves the question open why certain standard forms are chosen ... [and] begs the question of what limits the set of activities covered by a "standard form"' (O. Hart 1989: 1764). In the context of corporate law, certain critics have noted that the metaphor does not correspond to corporate practice. Further, the nexus-of-contract vision suffers from many technical problems when applied to corporate contracts; thus Kornhauser (1989: 1452-7) argues that the conditions of 'full information' and 'costless contracting' which define the ideal contract for Easterbrook and Fischel (1989) are undermined by the complexity of corporate decision making.

²¹ The 1980s take-over wave created a ground swell response in state assemblies for the protection of non-shareholder ('stakeholder') constituencies-i.e., managers, creditors, bondholders, and communities-which were harmed as a result of the transfer of risk. The promulgation of non-shareholder constituency statutes extended the traditional doctrine of fiduciary duty, which provides that a director's only duty is to the shareholder, to a new class of beneficiaries (see Rock 1992; Gavis 1990).

take-overs that threatened the position of stakeholders in the firm during the 1980s. As a response to this situation, Coffee advanced the general proposition that non-shareholders' interests should be protected from the effects of corporate restructuring. His proposition is based on a normative argument which claims that the ex post distribution of the shareholders' take-over premium is justified on efficiency and equity grounds. Coffee defines risk here in terms of the unbargained-for contingency which certain stakeholders are unable to insure against in the context of a hostile take-over. He challenges the alleged efficiency effects created as a result of increased risk in the firm. In terms of the efficiency claim, Coffee insists that the increased leverage does not lead to the most efficient redeployment of assets, through either financial restructuring or the market for corporate control. Secondly, the effect of the greater leverage creates diseconomies at both the state and the community level. Coffee's argument is based on a normative concern: namely, how to protect those stakeholders in the firm who have failed to safeguard their firm-specific assets from post-contractual opportunism in the form of wealth-maximizing ex ante agreements (see generally Shleifer and Summers 1988).

Let us first consider Coffee's proposition that the struggle over the level of risk is the fundamental conflict between shareholders and managers in the firm. Risk is an important concept in economic theory. It is normally defined as 'that part of future uncertainty that is relatively systematic and predictable, but which is still dangerous because it can bring financial ruin' (Shepard 1990: 251). Simply stated, risk is defined in terms of the probability of some hazard occurring. Another aspect of risk is its severity. The analysis of risk is not confined to economics, however. Indeed, risk theory has been extended to the institutional analysis of modernity in general. For example, sociological theorists offer a wider conception of risk, defined in terms of disappointment. Consider, for example, Niklas Luhmann's (1975) theory of risk. For Luhmann, risk is a key concept for explaining how a social system, defined in terms of an autopoietic system which is recursively organized and self-referentially closed, learns and evolves. Risk is connected to trust, which presupposes an awareness of risk. For Luhmann, a person who consciously engages in a course of action in order to avoid disappointment embraces trust. So, for example, a litigant who selects a course of action, such as pursuing a legal claim to its conclusion in the face of a settlement proposal, and is upset by the outcome, may be disappointed if she acknowledges that she was partly to blame. As a result of disappointments, the system learns.

To be sure, Coffee's use of risk is complex. I would argue that it is located somewhere between the sociological and economic approaches we have just discussed. For Coffee, risk is understood in the context of a bargaining process. The firm is defined as a bargaining site on which several co-operative arrangements are possible, and the parties have conflicting preferences over

them. Coffee rejects the fashionable view that the conflict between managers and shareholders is based on an attempt by the shareholders to monitor and control moral hazard, which is inevitable, given the problem of bounded rationality and the existence of transaction costs. The threat of a hostile takeover induces managers, who are normally risk-averse, to take higher risks, in order to avoid losing their future information rents. On this account, risk is understood in terms of contingency.

Coffee argues that the economists' moral hazard explanation is too coarse-grained to explain the increase in leverage. In its place he offers certain results from prospect theory. That theory provides that players will select low-risk strategies only if they are currently performing above their aspiration level, and, correspondingly, will alter their risk preference to a high-risk strategy when they are operating below their aspiration level. This insight is applied to the corporate decision-making context to explain the higher incidence of leverage in the firm. Taking his cue from the managerialists, Coffee contends that managers were able to price-satisfy until the late 1970s, because they met their expectation levels and could select low-risk strategies based on growth. He argues however, that the completion of the corporate control market changed that pattern and that, as a result, most managers, even those operating highly efficient firms, have altered their preference for low-risk strategies in order to avoid forced exit and the loss of their future rents.

Coffee maintains that under certain assumptions posited by modern financial ('portfolio') theory, that rational shareholders hold well-diversified portfolios and that fully diversified institutional investors dominate the share marketplace, rational managers tend to be highly risk-sensitive compared with shareholders, who are theoretically risk-neutral (Posner 1986).²² Three arguments are offered in support of this proposition. First, managers have an implicit contract for quasi-permanent employment, based on their assessment of their relative merit and their expectations of the growth of the firm. Moreover, managers highly value this employment relationship, and fear the potential loss of the firm's rents. Secondly, the manager has a high level of personal, as well as asset-specific, wealth invested in the firm and, as a result, is over-invested in the firm as compared with the shareholder with her diversified risk. Thirdly, managers may face personal and criminal liability for bankruptcy, fraud, or

²² Economists argue that shareholders do not suffer the most risk, because they are able to spread their risk across investments through a portfolio strategy. The dispersed nature of shareholding creates the classical free-rider problem: given the diffused shareholding in the firm, how do shareholders induce managers to act in their interests when the rational shareholder has no incentive to monitor management. Agency theorists argue that the executive labour market and the market for corporate control are the strongest mechanisms for curbing managerial misconduct.

securities manipulation, whereas shareholders are, for the most part, effectively shielded. On this theory, managers have little shield against firm-specific risk, so are highly risk-averse; whereas shareholders are theoretically risk-neutral. However, Coffee argues that this asymmetry is not wholly undesirable, since it reduces the moral hazard problem. Coffee seems, in the end, to support the increased level of shareholder power but, at the same time, wishes to protect those interests most exposed to the new level of risk.

Before addressing the asymmetry hypothesis, I want to mention some of the implications of Coffee's managerial risk hypothesis for an understanding of the problem of moral hazard and, more concretely, the market for corporate control. As regards moral hazard, Coffee contends that managers, because they are over-invested in the firm, have an incentive to entrench themselves further, rather than make *ex ante* value-maximizing investments. Echoing the managerialists, Coffee believes that two propositions appear to follow: (1) the introduction of high risk into the firm is an incentive for managers to maximize growth size and not to maximize profits (Coffee 1987: 83); and (2) managers tend to minimize risk by financing growth through internalized funds, and generally avoid, as far as possible, external contracts for finance (see generally Gintis 1990). Thus corporate managers are committed to non-value-maximizing decisions, which explains certain general features of modern corporations: (1) their excessive earnings retention; (2) managers' preference for fixed, as opposed to entrepreneurial variable, wage contracts.²³ The main point to be made here is that managers, because they are unable to diversify their risk, deploy the firm's assets sub-optimally (O. Hart 1989: 1769).²⁴ Indeed, Coffee parts company with the managerialists in part because of their failure to appreciate the external, market pressures on managers to make efficient decisions. He argues that the managerialist growth hypothesis explains the conglomeration movement of the 1960s and 1970s and the fierce defensive response of managers in the 1980s to avoid the harsh effects of the restructuring movement.

²³ This argument appears odd, since it seems that most managers do not actually select their own form of compensation package. Indeed, the agency literature argues that principals and agents draft *ex ante* agreements which include incentives, in order to align agents' interests. On this theory, even under an optimal incentive scheme, managers will tend to pursue their own interests.

²⁴ Hart argues that since moral hazard is ineluctable, expropriation problems can be avoided either by writing *ex ante* profit-sharing agreements or by parties sharing investment expenditures. Both suggestions may be insufficient to avoid moral hazard, since verifiability and ownership problems may create differentials.

2.4 Ex Post Settling Up

Let us now ignore the moral hazard question and ask how the implicit contract provides a justification for ex post redistribution of the shareholders' take-over premium. Here Coffee is drawing on the economic theory of the firm which characterizes the firm as a nexus of contracts. In this model, the firm is defined as a set of explicit and implicit contracts. Most of the terms of these contracts are incomplete, since they cannot be costlessly drafted and enforced (Charny 1991; Williamson 1985). A contract may be incomplete for another reason; for example, in that it is insensitive to economically relevant future events (Ayres and Gertner 1989: 92 n.29). over the length of these agreements, the parties will bargain over the incomplete terms (Charny 1991; Milgrom and Roberts 1990). In this model, managers and shareholders develop a set of expectations which are the result of continuous bargaining. In cases where the parties are unable to agree or clarify their differences about a missing term, the court is called in to fill in the gap (Ayres and Gertner 1989). Coffee contends that in the event of a hostile take-over the missing term for managerial compensation should be interpreted by reference to what the parties would have bargained for ex ante. This approach is flawed. That is, the simple bargain framework may lead to results which are either inefficient or unfair (Ayres and Gertner 1989; Charny 1991). To be sure, Coffee fully admits this strategy is limited. In the alternative, he offers an argument for a broader extension of fiduciary duties towards stakeholders generally. The difficulty with this argument is that it encourages managers to further protect their interests at the expense of shareholders. A more explicit argument against extending fiduciary duties to stakeholders is that it offers protection to groups who can obtain contractual protections and, as a result, it diminishes shareholder protection (Stetson Law Review Symposium — J. Macey 1991: 40-41).

On the first level, as noted above, Coffee draws on the implicit contracts literature to justify the ex post distribution. To be sure, he acknowledges that this literature was originally devised to explain why employers of low-wage labour made adjustments to demand by changing the quantities of labour rather than the price (Coffee 1987: 84). Here, Coffee attempts to extend the concept of the implicit contract to explain one feature of the internal managerial labour market—namely, the tendency of risk-averse managers to trade off some portion of their current wages in exchange for increased job security. This strategy has limitations. Collins (1993) complains that the contractualist approach attempts to explain internal wage variations in terms of supply and demand. However, he argues that internal market wage rates are set not merely by market forces, but by reference to social and administrative norms. Collins's point is that the internal labour market wage might be tied to a norm, rather than to the fluctuations of supply and demand. He attempts to generalize this claim, but his

attempt is only partially effective, since it assumes that all internal labour market wage rates are set by either norm or organization. To be sure, certain segments of the labour market will be market-influenced, and this seems especially true in the case of professional markets where there are sellers' propensities (Gilson and Mnookin 1990: 222-5).

The differential risk model has been challenged from a different perspective by Oliver Williamson (1987b: 159). In the first instance, the concept of an implicit contract is questioned, since it appears ambiguous and conceptually confused. More centrally, Williamson contends that the contractual problems of the firm are best understood in terms of *ex ante* contracting problems. Employing insights from transaction cost theory, the contracting problems between managers and shareholders can be addressed either in terms of incentives, including severance payments, or by recourse to a governance structure which can help resolve disputes. With this background, Williamson contends that in the context of a hostile take-over, in which the earlier contractual equilibrium has been disrupted, risk-averse managers are more likely to protect their firm-specific investment from hazard by recourse to contractual mechanisms. Williamson argues that the successor management should not be expected to renegotiate on the same terms, even if certain changes have occurred. To be sure, Williamson notes that the changed environment will produce at least one of three different changes: (1) a reduction in managers' firm-specific investment; (2) increased inducements to accept higher levels of hazard; or (3) insurance against loss of the firm's rent. It seems to me that Williamson's arguments are powerful, but could be usefully supplemented by an additional set of arguments against Coffee's implicit contracts thesis.

Coffee challenges certain aspects of Williamson's claims. First, Williamson's approach is unsatisfactory, since it assumes that the level of firm-specific capital explains the actions of managers. In particular, it is not at all clear that all managers have a particularly high level of firm-specific capital in the firm; furthermore, the existence of the executive labour market indicates that managerial skill is transferable, and not tied to a specific firm (Coffee 1987: 91). Coffee's major point is that the success of the firm in creating contractual incentives for managers to align their interest with that of the principals makes them more risk-averse, and explains their preference for growth and their aversion to debt.

The resort by Coffee to the implicit contract model invites a final comment. Rather than limit himself to a narrow claim that certain managers might be entitled to a premium share for an unforeseen risk, Coffee attempts to extend the point to address the normative question regarding whether anything should be done to offset the increased risk which certain groups, including the state and the community, have absorbed as a result of the hostile take-over. In order adequately to address this question, Coffee attacks the neo-classical vision of

the firm and the shareholder sovereignty doctrine. Both theories place the shareholder-principal at the centre of the firm, and state that, as the risk-bearing entrepreneur, the shareholder is entitled to control over the residual, and is the only group in the firm which is owed fiduciary duties. I suspect that Coffee's use of the implicit contract hypothesis requires some unpacking on this point.

Coffee, in the main, aspires to offer a theoretical account of the firm which might provide an alternative foundation for corporate law. This approach is based on the following claims. First, as mentioned earlier, Coffee defines the firm as an imperfect and unstable risk-sharing arrangement, which translates into a more flexible vision of the firm. The principal is displaced from the centre of the firm, and the ex post struggle over the residual profit is not determined by one party but is a bargained-for outcome (Coffee 1990; Rock 1992: 545). Following the insights of the implicit contract thesis, Coffee argues that the shareholder is not the only risk-bearer in the firm. Because managers are risk-averse and are unable to get full insurance, they are highly exposed and, as a result, unable to protect their firm-specific assets. Against this background, managers make implicit contracts to protect this investment, which are breached by the hostile take-over. Arguing from fairness, managers should be compensated in the form of ex post devices like the golden parachute. The ex post devices are defended on the grounds that it is difficult to evaluate managers' behaviour ex ante, and that by offering ex ante incentives managers, might have an incentive to act opportunistically.

Coffee's account is not fully convincing. At this point, I will consider the economic arguments that Coffee employs in support of his claim justifying ex post distribution of the premium share. First, it might be equally well argued that the management compensation package negotiated by managers, in most instances, would include an insurance premium against the risk of forfeiture of future information rents. This would most certainly be the case for those managers hired since the hostile take-over market reached maturity in the early 1980s (Eisenberg 1987). Even if certain senior and junior managers did not sign complete contracts, one would expect that the principal calculated the costs for all imaginable future hazards into the terms of the contract (*ibid*).

Coffee justifies the ex post compensation for managers in terms of efficiency. The claim here is that take-overs are necessary to reduce opportunism, but that management should receive a share of the take-over premium in order to compensate them for the unbargained-for risk as well as to smooth the transition. The efficiency grounds for this proposition are challenged by Brudney (1988 : 153), who rightly argues that 'the case for management's need for more protection at take-over time is hard to see in the light of the immense discretion that it has during the operation of the company to reward itself generously for its sacrifice in limiting its talents to firm-specific dimensions'.

Brudney's point is that the aim of take-overs is not to supply management with more rewards, after it acts against shareholders' interests.

Two observations are relevant to our discussion. First, managers tend to make manager-specific contracts because they are harder to monitor and punish.²⁵ These implicit contracts are usually based on the reputation of the manager, and are part of the manager's own human capital (Aoki 1988; Kreps 1990; but see Williamson 1992). On this theory, if a manager can arrange for implicit contracts with the firm's most valuable employees and suppliers, he can extract a higher wage from shareholders. The degree of entrenchment depends on how highly the firm's assets are dependent on the incumbent manager's skill and knowledge. On the other hand, if the board removes the manager, he is able to exit with his contracts and commit himself to another. As a result, the fact that the incumbent firm stands to lose certain rents if the manager exits indirectly commits the shareholder to a reward rather than a punishment policy.

This model explains managers' objectives in terms consistent with those elaborated by Coffee. Shleifer and Vishny (1988) contend, like Coffee, that managers tend to further entrench themselves because they are overinvested in the firm. At every level of selection there is always a group of employees that have an interest in entrenching themselves. As a result, managers that are inefficient are least likely to be able to move between firms and have an interest in taking actions that are value-reducing to shareholders. The main insight is that managers collecting rents attempt to do whatever they can to collect their future rents. Thus they will tend to make value-enhancing investments beneficial to the shareholder only if this choice further entrenches them. Several insights suggest themselves. First, Coffee, like Shleifer and Vishny, believes that the hostile take-over is an inefficient weapon for disciplining managers, and may have the opposite effect. Second, a highly organized group of managers will mobilize, as they did in the 1980s, to influence legislation which protects them from potential loss of their firm specific capital (Macey 1988). Taking these points together, the effectiveness of incumbent management to protect its interest should not be underestimated.

2.5 Conclusion: Trust and Implicit Contracts

The differential risk hypothesis attempts to justify ex post compensation to managers on the grounds of efficiency gains. In particular, Coffee claims that ex post compensation is necessary to pay off the losers, in order to reduce the

²⁵ Manager-specific investments include acquiring and divesting businesses which add to managers' position and making implicit contracts with the firms' employees and clients.

inefficiencies that result from managements' defensive responses to hostile take-overs, and at the same time to maintain the loyalty of managers. Such payments should protect the most risk-averse managers and restore the equilibrium between the various interests in the firm. However, Coffee does not explain the basis for such implicit contracts. This question has been addressed by theorists who rely on a notion of trust or reputation.

Proponents of the rational reputation or trust approach explain, like Coffee, that complete contingent claims contracting is expensive, hence shareholders prefer to rely on implicit contracts with stakeholders (Shleifer and Summers 1988: 37). The problem is to explain what motivates stakeholders to sink investments in firm-specific capital if there is no mechanism to sanction shareholders who breach their promises to stakeholders.

Trust is relevant to implicit contracting, because it recognizes that individuals act opportunistically, and it explains the circumstances in which individuals will honour a promise or agreement (Elster 1989: 274-5; Dasgupta 1988: 53). The concept of trust is defined in term of credibility.

A related approach in terms of rational reputation (Kreps 1990) is based on insights from non-co-operative game theory. This assumes a continuous bargaining game with a high probability of repeated bargaining rounds. Kreps argues that managers honour implicit contracts because it gives them a good reputation: 'I will begin by trusting you hoping that you will honour that trust. Indeed, I will continue to trust you as long as you do not abuse that trust. But if ever you abuse that trust, I will never again trust you' (Kreps 1990: 102). In a repeat game, if the manager adhered to the implicit contract in the earlier round, the manager will continue to honour the contract, since it generates a reputation for trust and hence increased capital for the firm. Limitations to the Kreps model are that it assumes that the only reason to trust a manager is her reputation (Shleifer and Summers 1988: 39), and assumes that a shifting constituency such as shareholders knows what a manager did in the earlier round (Williamson 1992: 167).

The role of trust has been applied to the take-over context by Shleifer and Summers (1988). They argue that hostile take-overs disrupt the implicit long-term contracts between shareholders and stakeholders. They refer to psychological evidence which they claim shows that people trust others for reasons other than reputation. Since this cannot explain trust, they argue that shareholders tend to select trustworthy managers, because this maximizes utility. While it is not clear what the selection mechanism may be, they claim that managers must pass through a 'loyalty filter' before promotion to positions of trust. Applying this model to take-overs, they argue that the extent to which managers are able to defend the implicit contracts made with stakeholders depends on their level of entrenchment and their willingness to honour those agreements. Shleifer and Summers see take-overs as rent-seeking devices, and

challenge the view that net efficiency gains are achieved. While they concede that there may be some efficiency gains, they contend that there may be greater long-run efficiency losses due to the loss of trust which facilitates long-term contracting.

This argument turns on the view that shareholders prefer trustworthy managers who will entrench themselves and honour implicit contracts with stakeholders. Holmstrom persuasively challenges this claim, arguing that the fact that a manager is trustworthy does not ensure commitment (Holmstrom 1988: 57-8). Further, it seems that the entrenchment claim fails to explain why the present shareholders do not capture the rents from the implicit contracts. Holmstrom prefers to explain managerial behaviour in terms of managers' rational concern for their careers. Hence, they act to maximize their position within the firm, and respond only to the groups with the most voice or the greatest power. However, this self-interest model does not square with trust.

Finally, a major difficulty with the breach of trust claim is that it is without empirical support. As we have seen earlier, the recent empirical studies analyzing the large gains in shareholder wealth that arise from take-overs shows that the primary source of wealth is related to the anticipation of the post-take-over divestitures of the target firm's assets. Added to this point is the finding by Bhagat et al. (1990) that the reduction in labour costs and transfers from bondholders amounted to an insignificant aspect of the wealth increase overall. Based on these considerations, my conclusion is that the implicit contracts model is inaccurate in empirical terms and its normative foundations are questionable.

CHAPTER 3

REPEATED GAMES, SOCIAL NORMS AND INCOMPLETE CORPORATE CONTRACTS

3.1 Introduction¹

Recent legal theories of the firm tend to build on a foundation of economic contract. This chapter shows, first, that there are sharp differences among the economic models of contract available to lend content to these contractual firms, and, second, that the descriptive and normative implications of these differences have yet to be fully appreciated in the legal literature.

We begin with the contractarian firm, the economically-grounded description that has become standard in contemporary American corporate legal theory. We move on to describe and contrast an incomplete contracting model of the firm that follows from a very different set of economic assumptions. We then combine this model with basic points from the literature of repeated games. Taken together, they support two assertions. First, under certain conditions rational actors will not ground their firms in contracts. Second, contracts made in connection with firms are likely to be so incomplete as to render any available theory of contract inadequate as a basis for a law of the firm. We argue that this incomplete contracting model provides a more plausible basis for describing corporations than does the contractarian model. We also explore some of its normative implications.

In section 3.2 we draw on our incomplete contracting model to show why firm contracts do not function in the fashion predicted by the contractarian approach. There we also situate our approach within the existing range of incomplete contracts models. All of these describe contracting problems which leave parties with less than the information necessary to approximate their first-best expected utility. But they offer different conceptual techniques for dealing with these problems. Some closely resemble the contractarian theory of the

¹ William Bratton and Morten Hviid collaborated with me on writing this paper which appeared in: C. Willet (ed.) *Fairness in Contract* (London: Blackstone Press 1996).

firm in seeking to complete incomplete firm contracts by approximating a theoretical contract that succeeds *ex ante* in describing all future states of nature. Our model of incomplete contract draws on a different body of economic literature to insist that the very fact that parties are limited by what they can put into a contract denudes the attempt at *ex ante* approximation of feasibility. A regime in which legal decision-makers take an *ex post* perspective that supersedes the bargain of the parties becomes inevitable.

The suggestion that a legal-decision maker legitimately might supplant the parties' bargain (whether actual or hypothetical) creates a considerable problem for an economic theory of the firm. Without the bargain (actual or hypothetical) as a base point, the theory lacks an obvious source of normative content for the *ex post* gap-filling exercise. In section 3.3, we suggest that game theoretic models of repeated games can be drawn on to solve this problem. Here we outline the basic features of repeated game models and their implications for understanding long term production relationships. We show the robust pictures of private enforcement strategies and relational stability that have evolved in the repeated game literature. These now can help us understand how, given conflicting parties in situations where contract is not feasible, trust and co-operation can emerge to benefit the parties.

In section 3.4 we expand on the literature of repeated games to examine its points of influence on recent discussions of corporate contract theory. This discussion shows that the process of breaking with contractarianism already has begun, but that the full implications of the repeated game models and related principles of incomplete contracting have not yet been articulated in the corporate law context. Section 3.4 completes this discussion by drawing on a new line of social theory. This approach, which also draws on game theoretic models of co-operation, offers a behavioural description in which trust and rational calculation co-exist and complement one another. We argue that this description provides the basis for a theory of the firm that admits both contract and a positive law of fiduciary duty as independent elements.

3.2 Contractarian Theory

Under the contractarian theory dominant in American corporate law during the past fifteen years, the firm has been viewed as a set (or 'nexus') of incentive contracts (see Bratton, 1989). This theory derived from the principal-agent theory earlier developed in economics and extended it in a number of directions.² According to the contractarian theorists, the primacy of contract

² More specifically, contractarian theory combines two related theories (agency costs and the efficient market hypothesis), and states that managers will have an incentive to create

implies that corporate law should contain no mandates, only default terms. In addition, legal decision-making respecting firms should be treated as an exercise in contractual gap-filling pursuant to the 'hypothetical contract principle', a universal norm to guide decision-makers in supplying default terms and filling gaps. Under the principle, the legal system supplies the rule which both parties to the contract would have adopted had they addressed the matter *ex ante* in a costless world. Terms that follow the principle, says the theory, will be efficient for all situations. And, because the theory's operative class of 'contracts' includes any and all voluntary economic relationships, the field deemed appropriate for application of its regime of *ex ante* default rules and gap fillers is quite large.

The literature on contractarian theory begins with rational, well-informed actors and asserts that prevailing governance systems result from their efficient, equilibrium choices. The presence of competition makes this assertion plausible: We can assume that existing arrangements, whether nominally stemming from contract or positive law, result from efficient, equilibrium choices because, in the long run, only efficient choices will survive (see Johnston, 1993). Contractarian theory then shifts its time reference to future arrangements to assert that contract trumps mandate because rational, well-informed actors contracting *ex ante* can be expected to do a better job at economizing on transaction costs and devising safeguards against opportunism than can legal decision-makers intervening *ex post* (see Williamson, 1993). The legal regime's only function is to provide *ex ante* cost economies by providing pre-packaged default rules formulated under the hypothetical contract principle (see Easterbrook and Fischel, 1991). In the final contractarian picture we get a complex of contract terms that govern all future contingencies, all derived *ex ante*, either in fact or by hypothesis.³ A normative admonition greets a party who shows a loss *ex post* caused by another's opportunism: Since you could have contracted to protect yourself, you should have done so. The positive law of the firm serves only to open a field for self-regulation, and intervention to impose duties on corporate actors pursuant to juridical notions of responsibility should be avoided as unproductive.

But the contractarian description has a significant shortcoming. It gives us

legal rules which mimic the market. In general terms, the function of corporate law is to design an efficient set of default rules to govern the rights and duties among members of the firm. Thus conceived, corporate law, as a set of efficient default rules, reduces the costs of contracting. See, Easterbrook and Fischel, 1991.

³ A complete contract is a contract that all the relevant and foreseeable contingencies are foreseen and that the parties have agreed on efficient provisions for each state contingency. *Ex ante* completeness also assumes that the parties will implement the contract and not renegotiate *ex post* the terms of the agreement. See generally, Moore, 1992.

ex ante contracts across-the-board and thereby makes corporate governance entirely contractual without providing a description of the processes by which corporate actors make contracts (see Johnston, 1993). It avoids the necessity of a theory of bargaining with two assumptions – that bargaining is relatively cheap and that competition will force parties to bargain their way into efficient arrangements.⁴

3.3 From the Complete Contracts Firm, through the Incomplete Contracts Firm, to the Firm Without Contracts

Incomplete contract models deal with the problems that arise when contracting parties possess less information than is necessary to approximate their first-best expected utility. Most work on incomplete contracts falls into one of two basic paradigms: the transaction costs approach and a contrasting approach which derives incompleteness from first principles. The transaction costs approach already has received the complete attention of those who work on the theory of the firm, and, indeed, has been assimilated into contractarian theory. The component ideas of the first principles approach have only just begun to show up in legal commentaries.⁵ We argue in this section that they suggest a thorough-going, process-based challenge to the contractarian paradigm.⁶

Under the transaction costs view, the problems which arise from attempting to write *ex ante* contracts are due to a diverse range of transaction costs. First, it is difficult for parties to anticipate all the possible state contingencies that might arise, and design the contractual provisions to deal with them. Second, even if the parties could specify all the relevant contingencies, it may be impossible for the parties adequately to specify these future states in order to forge an agreement. Third, there are too many contingencies making it difficult for the parties to write them into a contract. Fourth, the costs of verifying the performance of the party may make create disincentives to write a complete contract. Fifth, the enforcement of the contract is expensive. The transaction costs model asserts that the cumulation of these costs prevents actors from

⁴ The mandatory/enabling discussion in US corporate law developed on the weakness of these assumptions, concluding that information asymmetries, along with shareholder collective action and rational apathy problems, prevent effective bargaining and make certain actual contracts suspect. The apparent weakness of the contractarian approach left open a place for normative mandates in the field of corporate governance. However, mandates were subsumed in the larger complex of hypothetical contracts.

⁵ See e.g., Ayres, 1991.

⁶ In the discussion which follows, we will use the term incomplete contracts approach to cover situations where there are asymmetries of information and possibly problems of third party verification or private information.

negotiating a complete *ex ante* solution to all problems. But it goes on to take on entirely *ex ante* perspective in dealing with the problem, asserting that actors putting capital at risk still can be expected to design *ex ante* governance structures that minimise the costs of future uncertainty. Furthermore, it insists that legal decision-makers assisting the parties by providing terms *ex post* should cast those terms from an *ex ante* time perspective in order to guard against disruption of the parties' allocation of financial risk and to minimise future transaction costs. As a result, it tends to join contractarian theory at the normative bottom line to counsel self-protection through explicit contract and impose an overwhelming presumption against legal intervention to protect dependent actors.

What we term the 'first principles' paradigm of incomplete contracts begins with the same definition of incompleteness as the transaction costs approach but goes on to make a number of contrasting claims, both substantive and procedural. The substantive claim brings the notion of incompleteness to bear on a more precise conception of 'contract'. More specifically, *ex ante* incompleteness is due to the formal nature of the contract in addition to the costs of complete specification. Thus, unlike the transaction costs approach and its inclusion of any voluntary economic relation within its notion of contract, the first principles approach usually looks to situations where a contract must be explicitly specified by its parties in order to be recognised as such and enforced. That is, to have 'contract' terms that govern future states, those contingent states must be specified and the future outcomes must be computable. Since some future states of nature clearly are not computable, transacting parties as a result lack the technology necessary to enable the negotiation and composition of a contract term *ex ante* (see Anderlini and Felli, 1994). Indeed, under certain conditions problems concerning specification of future contingencies become so intractable that rational parties in search of gains from trade may proceed to transact without writing a contract at all.⁷

The first principles approach also draws on bargaining theory to recognise the collection of process infirmities that also limit the utility of contract. Bargaining theory models the problems that come up when relational economic actors transact. It asserts that, even where parties could cost-beneficially specify a contract term, information asymmetries and strategic behaviour may prevent them from so doing. This implies that bargaining processes often shape contractual results, and in turn leads to the question whether a viable set of

⁷ This literature takes seriously the idea that there may be no contract. We should note that there are varying degrees of contractual incompleteness: in particular: it assumes intermediate forms of incompleteness which limit transaction costs by resorting to third parties to *ex post* decide the contractual outcomes; see Tirole, 1988.

governance provisions for a firm can be derived through any available model of contract. Some bargaining models show co-ordination failures: Rational actors can conceivably adopt any one of a number of mutually consistent arrangements and market forces may fail to assure that only efficient patterns emerge from the range of possibilities.⁸ Other models identify costs of bargaining that prevent efficient results. Consider a price negotiation over the sale of a nonfungible product. A buyer seeking a greater share of the gains of trade might invest in quality information to gain a bargaining advantage. Such an investment in a pure distributional advantage is inefficient, since only total benefits and costs matter from an efficiency standpoint (see Milgrom and Roberts, 1990). In the alternative, each bargaining party stands to benefit from the communication of information about its own preferences. The resulting informational uncertainty can result in the loss of a beneficial transaction, and induces inefficient informational investment in any event.

The first principles approach thus recognises three limitations on the zone of *ex ante* contracting—technological failure, private information and strategic behaviour. Taken together these limitations permit us to see that the contract-based vision of corporate law suffers from two fundamental limitations. First, contrary to the nexus of contracts approach, the firm cannot plausibly be described as a sum of contractual parts.⁹ The reason is simple—costs and technological limitations prohibit bargaining across the range of pertinent contingencies (see Milgrom and Roberts, 1992). Second, fundamental questions must be asked about the viability of the central contractarian assumption that contracting agents will bargain to optimal arrangements if left to their own devices. It is this premise that permits the theory to complete the incomplete contracts that actors conclude in the real world by drawing on the hypothetical contract principle, and to recharacterize corporate law's set of positive instructions as contract terms (see Easterbrook and Fischel, 1991). If, as the first principles approach suggests, information asymmetries may cause the parties to fail to bargain their way to an efficient term even in a costless environment,

⁸ The standard assumption that markets will overcome co-ordination problems give competitive supply conditions is not safe where multiple goods are involved and more than two parties must agree in order for exchange to go forward.

⁹ The contractarian approach relies on the principal-agent theory as a framework for analyzing governance issues which involve members of the organization. (See Easterbrook and Fischel 1991 pp 1-39). Principal-agent theory addresses the central problems of economic organization and motivation through the design of optimal contracts which distribute incentives and risk-sharing effectively. These contracts are *ex ante* complete in that they specify for the relevant foreseeable contingencies. Hart points out, however, that the complete contracting assumption necessarily excludes a role for corporate governance in that there is no role left for a mechanism to decide residual issues of control: Hart, 1995.

(see Fudenberg and Tirole, 1991), then it follows that the existence of meaningful hypothetical contract terms cannot be assumed. Further, given the complexity of corporate situations, actual negotiated corporate contracts will not necessarily be optimal even where they exist in the real world—the parties (and by implication the economists who write about contracts) quite simply lack the technological wherewithal to create such ideal governance arrangements. If contracting can be inefficient, then its frequent absence in the practice of real world corporate actors makes complete sense, and the choice of legal institutions, as opposed to that of contractual terms, can be the primary influence on the efficiency of the outcome (see Fudenberg and Tirole, 1991).

We note that this analysis implies a modification of contractarian theory's descriptive and normative bottom lines only to the extent that bargaining costs and effects of technological failure are nontrivial. As to bargaining costs, competition certainly will assure triviality in some cases. But the bilateral monopoly situation that accompanies firm-specific investment strongly suggests that the bargaining costs of firm governance are nontrivial (see Milgrom and Roberts, 1990). The same conclusion should follow for technological limitations if recent experiences with standard American corporate contract forms may be taken as a guide. The inadequacy of the standard terms employed in contracts governing senior securities is widely acknowledged. The inadequacy of the stock of terms governing junior equity investments is acknowledged even more widely. Here investment proceeds under contract terms and state-supplied governance structures that leave open such constant risks of opportunistic exploitation that contractarian theory, even at its high point, never quite succeeded in delegitimizing American corporate law's apparatus of fiduciary protection.

Once contract's significant bargaining costs and technical limitations are acknowledged, serious questions start coming up about contractarian theory's basic assertions. How, given contract's institutional limitations, can we safely assume that rational actors ground their firms in *ex ante* contractual risk allocations? And if that assumption is unsafe, how can the law be left to follow the contractarians advice and remit actors to *ex ante* contracting, when so doing would invite them to dissipate resources?

But these questions can be countered with other questions: If not contracting, then what? How, given opportunism, can co-operative production go forward without a complete backstop of state-enforced promises, actual or hypothetical? One answer, according to non co-operative game theory, lies in reputational incentives. Game theoretic models of spontaneous order suggest that, given reputational incentives, rational actors can produce co-operatively without any contracts at all (see Boot, Greenbaum and Thankor, 1993). By providing a working description of the economics of production in the absence of contracts, these models provide us with a theoretical base point for a theory

of the firm that admits an *ex post* approach to the incomplete contract – an approach pursuant to which an intervening court legitimately could supplant the parties' bargain. This approach, by recognising that the parties are limited in what they can write into a contract,¹⁰ would invite legal decision-makers to consider a range of possible default rules as supplements for the bargaining process. Ultimately, it would even sanction the use of corporate law's inherited normative framework in the *ex post* solution of non-contractible problems.

3.4 Repeated Games and Folk Theorems

Sovereign enforcement is a problem for all contracting parties, at least in the absence of a mechanism that instantaneously and costlessly translates counterparty breach into a present payment of correctly calculated damages. Even given a perfect *ex ante* specification of an aggrieved party's rights, a breach may turn out to be difficult (and costly) to observe or, even if easily observed, may be difficult (and costly) to verify to a legal decision maker. These problems tend to become more serious, and sovereign enforcement less and less feasible, as the contract becomes more incomplete. As a result, informal enforcement mechanisms such as reputation become essential components of such contracting relationships. Indeed, given a completely effective reputational enforcement mechanism, parties can dispense with the institution of sovereign-enforced contract all together. The medieval merchant guild is said to provide an historical illustration of such a mechanism: the merchant guilds were established to create a reputation mechanism in which merchants overcame rulers' commitment problems (see Grief, Milgrom and Weingast, 1994 and Milgrom, North and Weingast, 1990).

Today, game theory's models of repeated games offer theoretical descriptions of the behavioural and structural requisites for stable, informally enforced co-operative relationships. These models seek in terms to provide a formal theory of relational exchange in the absence of contract. In so doing, they have the incidental benefit of enhancing our understanding of the behavioural and structural components of incomplete contracts (see Milgrom and Roberts, 1992). They confirm the feasibility of incompletely specified relationships and also enhance our appreciation of the useful support provided to these relationships by both social norms and legal intervention grounded in noncontractual presuppositions (see Kandori, 1992).

Here in section 3.4 we examine some ways in which repeated game models show how trust and co-operation can emerge absent contracts and despite

¹⁰ Hence, central to the idea of incomplete contracts is the role of courts in interpreting gaps in contract. Cf. Schwartz, 1992, pp. 76-108; see also Tirole, 1992 pp. 109-113.

conflicting interests. Section 3.4.1 begins with an introduction to the basic elements of repeat games. Section 3.4.2 shows how these models' description of reputational enforcement has become more robust over time. In section 3.4.3 we compare the properties of finitely repeated games to those of infinitely repeated games. In sections 3.4.4 and 3.4.5 we report on the terms of some cutting edge models that make notable moves in the direction of realism as they identify strategies likely to enhance co-operation. Section 3.4.6 describes a repeat play theory of the firm.

3.4.1 The Folk Theorem and Repeated Games

We turn first to the Folk Theorem for repeated games. A repeated game is defined as a T-fold repetition of a particular (stage)game. In the simplest version, at each stage the players know the past history of the game including the past actions by all players. Loosely speaking, the Folk Theorem states that if the players are sufficiently patient and the game is repeated for a sufficient number of periods, all outcomes of the stage game which are individually rational¹¹ and feasible can be supported by some punishment strategy.

We can illustrate this by outlining the repeated trust game of David Kreps. The stage game, which is to be repeated, has a sequence of two moves in each round (see Kreps, 1990). Party A has to decide whether to put herself at hazard by trusting Party B. If Party A accepts the hazard and trusts Party B, Party B then has to decide whether to honour or abuse A's trust. The payoffs are set so that the trust/honour outcome maximises the joint gain, but that B's immediate gain is maximised through abuse of A's trust. In a one shot game the trust will be abused, and Party A, being rational, will not place herself at risk in the first place absent an enforceable contract protecting her investment. But, as noted above, high drafting and enforcement costs may preclude that alternative. Repetition of this situation increases the number of equilibria. Given enough repetition, trust will emerge and Party A's investment can be made without a contract. The repeated game scenario works as a self-enforcing trust/honour arrangement so long as there is a high probability that each round will be followed by a succeeding round: B's expected payoffs from future rounds deter defection and induce co-operation in the present round, provided that A can see what B is doing and stands ready to discontinue play, punishing B, if B ever defects from co-operation. (Note again that an important aspect of the model is that the players can observe one another's actions in each repetition, so that the deviations from equilibrium strategies are detectable.)

¹¹ An outcome is individually rational for a player, if it gives that player a pay off at least as high as its minimax payoff.

Given an *ex ante* projection of this repeat play scenario, investment in a protective contract by the parties would be irrational.

We can sum up by abstracting a relatively simple idea from the Folk Theorem: if the game is repeated a number of times and the transaction's profitability is high, it is likely that a co-operative strategy which is an efficient equilibrium will emerge. A player will invest in his reputation and co-operate so long as that player values the returns from co-operation over time higher than the short-term gains of opportunistic behaviour. Thus the player's self-interest serves as the mechanism that overcomes the collective action problem; here self-interested rationality and co-operation are synchronised. But a couple of requisite conditions must also be noted. First, the reputational interest that makes co-operation consonant with self-interest emerges within the context of repeated transactions.¹² Second, the model presupposes credible threats and assumes that they can inform and shape current behaviour; self-enforcement will be effective only where there exists a retaliation mechanism for players who transgress.

3.4.2 Strategies which Support Co-operation¹³

One of the earlier approaches to the study of perfect folk theorems relied on a severe and unforgiving punishment strategy to deter each player from cheating. Following a deviation, all players revert to choosing their myopic best reply forever. In the trust model, if a deviation is observed by player A, it refuses all future co-operation. The problem with this approach is that, because punishment goes on forever, there is in some sense too much punishment.

Dilip Abreu made an important contribution towards the elimination of this problem by successfully introducing the possibility of forgiveness. He constructed a simple set of punishments (the Stick) and rewards (the Carrot) that yield the maximal cooperation which can be supported given the possibility of defection (see Abreu, 1986). The theory is based on a punishment path which punishes harshly for just enough periods so as to wipe out the original gain from cheating and then forgives totally and reverts to the co-operative path. Any deviation from the punishment is met by restarting the punishment. Significantly, only a very simple informational structure is needed to sustain collusion under this strategy. All you need to do is calculate the stick, the carrot, and the length for which the stick must be wielded.

¹² But the number of such transactions need not be infinite--reputation also emerges in short-term relationships. Tirole, 1992.

¹³ For a summary, see Pearce, 1992.

Other models introduce uncertainty and informational asymmetries and show that they mainly pose a technical challenge, with folk theorem-like results appearing despite the introduction of modifications. For instance, if a player only receives a garbled signal about what the other player has done and hence does not know this period's result is due to dishonesty or bad luck, a punishment phase will have to be initiated in some cases. Hence, we will observe sporadic bursts of punishment where information is incomplete. But this should not be interpreted as the end of co-operation, but rather as a sign that co-operation can work in less than perfect conditions.

Credible punishment strategies also have presented barriers to the development repeat game model with robust implications for the world of practice. The problem with the punishment strategy that supports co-operative outcomes is that in many cases both the guilty and the innocent are harmed by the punishment. The punishment phase is still credible because any failure by party A to punish results in party A being punished. But a problem remains. Punishment itself hurts party A because it entails foregoing a higher co-operative payoff. The guilty party B therefore has an incentive to seek more immediate forgiveness and party A has an incentive to give it. This (although the parties proceed here without a contract) is termed the problem of 'renegotiation' after a deviation. The possibility of forgiveness through renegotiation threatens the overall co-operative outcome – if deviations from co-operation are not punished co-operation will break down.

This analytical tension has led some researchers to look for punishment strategies which are proof to renegotiations. The resulting literature is problematic, however. A large number of possible definitions of renegotiation proof equilibria has emerged reflecting different (and conflicting) interpretations of what renegotiation proofness means. But regardless of which definition of renegotiation proofness is used, renegotiation proofness does reduce the number of possible outcomes, although in some cases not by very much and in others by too much if no renegotiation proof equilibrium exists. In effect, the jury is still out on this concept and one should proceed with care.¹⁴

This discussion of renegotiation mirrors a discussion familiar in the field of contract law. As is well known, even complete specification of terms and sovereign enforcement do not cure the problem of incentive to forgive breach where the victim of the breach has an economic interest in continued performance. The contract law solution is of course a rule of unenforceability for

¹⁴ Pearce (1992) argues that the appropriate definition is case specific. Furthermore, if renegotiation is really a concern, it should be modelled explicitly, i.e. it should be part of the description of the game that at certain points in time the original agreement can be renegotiated.

a class of suspect modifications. Such a rule permits the victim of opportunism who renegotiates to counter-defect at a convenient future time and thus deters breach *ex ante*. From the point of view of contract doctrine, then, the extent to which renegotiation proofness is a real worry depends on the courts attitude to contract modifications (see Baird, Gertner and Picker, 1994).

But it must be noted that, even assuming a successful doctrinal solution, renegotiation proofness will remain an economic problem in the world of transactions so long as contract enforcement is costly and many contracts are incomplete. An alternative theoretical suggestion, is thus worth considering: A social norm entailing punishment for cheaters would clearly support co-operation and accordingly would prove useful (see Deakin, Lane and Wilkinson, 1994). It follows that the contrary social norm of forgiveness, which is often preached but rarely followed to the letter, might be detrimental to society's ability to sustain co-operation. Note also that this social norm against cheating serves to introduce a second, alternative technique of informal enforcement (see Kandori, 1992). The first mode, employed in all the models described up to now in this part, is personal enforcement. Under this enforcement against defection is ensured by repeated interaction among the players themselves. Under the second mode, the community supplies social norms in order to achieve efficient, co-operative outcomes.

3.4.3 Finitely Repeated Games

Significantly, the co-operative equilibrium does not prevail for those scenarios in which the number of projected plays, however large, is finite and known (see Kreps, Milgrom Roberts and Wilson, 1982). In order to see this point, let us return to the trust game and let it be based on a finite repetition. In this case Player B's incentives revert to defection at the last round. But Player A will anticipate this and will not trust Player B in that last round. As a result, the penultimate round becomes the last round from B's point of view. Player A in turn anticipates this shift, and will not offer trust in the penultimate round. The third-to-last round then becomes the last round, and so on. Ultimately, this process of backward induction leads to the collapse of the whole scenario of co-operation, and defection becomes the dominant strategy *ex ante* (see Benoit and Krishna, 1985). Central to the idea of self-enforcement, therefore, is the insight that co-operation is not likely to emerge if the end period is known (see Baird, Gertner and Picker, 1994).

Before we go on, we should note that finitely repeated games suffer from a limitation that makes them a case that approximates only a special class of

real life finite repetitions.¹⁵ The limitation is the fact that the identity of the last play is by definition specified *ex ante*. Such advance specifications are not always present in real world finite play situations. To see this point, compare a bond and a share of publically-traded common stock issued by the same corporation. The bond, with its due date, is a real world investment that does roughly resemble a finitely repeated game. Unsurprisingly, bond investments are made under relatively complete (albeit imperfect) contracts – a legally enforceable promise to repay on the termination date must be there at a minimum. Now compare the conditions surrounding investment in the stock. No member of either of the groups of parties to the corporate equity relationship – the shareholders and the managers – may anticipate an infinite duration. Yet all of these parties nevertheless may operate with an indefinite, long-term time horizon lacking a fixed termination date.¹⁶ Infinitely repeated games in which the duration of play is at any given stage stated probabilistically closely approximate these conditions.

Putting these *caveats* to one side, it is worth noting that with some restructuring of the base of assumptions, co-operation can emerge in finite play situations. There turns out to be a material difference between finite play models where the stage game has a unique equilibrium, such as the trust game and more generally the Prisoner's dilemma, and models where the stage game has multiple equilibria. In the former case, co-operation does not emerge. With multiple equilibria things work differently. One can construct good and bad endgames consisting of different selections of the stage game equilibria. The best endgame then becomes the carrot and the worst endgame becomes the stick. The length of an endgame needed to wipe out any gain from deviation is independent on the actual number of repetitions. Hence by increasing the number of repetitions, we can get as close as possible to the outcome which would emerge with an infinite repetition (see Kreps 1985).

There also is another way to avoid the non-co-operative result in the finite repetition situation. Again the assumptions are changed. The model dispenses with the assumption that the players know the exact characteristics of the player they are facing.¹⁷ To see the implications of this strategy, let us return to the finite trust game, modifying it so that players have incomplete informa-

¹⁵ See for instance the discussion by Rubinstein, (1992).

¹⁶ Special end period situation such as mergers and tender offers are exceptions. Unsurprisingly, American fiduciary law has articulated a special set of stricter rules for these situations.

¹⁷ Kreps, Milgrom, Roberts and Wilson, 1982 developed a model in which they introduced a one-sided asymmetric information in the finitely repeated prisoners' dilemma. They showed that if they only introduced a small amount of information about one player's type, it will have a large impact on the players tendency to cooperate.

tion about who Player B really is: There is some small chance that Player B is not a rational economic actor at all, but is an irrational type who will respect trust despite self-interest. A very small probability that a given type of Player B is an irrational type will restore the trust/honour outcome for most of the game so long as the number of repetitions are large enough. As the probability that Player B will respect trust increases, Player A's investment is more easily induced. Interestingly, in this class of games, the particular patterns of co-operative results hinge on particular assumptions about the type of 'craziness' about which the Player B is attempting to generate a reputation. Given the right type of 'craziness', a unique outcome can emerge in contrast to the folk theorems. But by choosing another type of 'craziness', the same set of equilibria can be supported as in the folk theorems.

3.4.4 Co-operation amongst Mortals and over Generations

We return to infinitely repeated games to take up the relaxation of another important limiting assumption. In the models we have described up to now, the cast of players always has remained the same and all players have stayed in the game forever. This rigidity as to the players' identities limits the model's potential as a source of practical learning, since the world of long-term economic relationships tends to present situations where finitely lived agents come and go against the backdrop of an infinite time horizon. Happily, these conditions have successfully been introduced to the infinite repetition models. With these modifications, the literature begins to produce the components of a theory of the firm.

Allowing for differences in the identity of the players over time turns out to be a minor modelling problem. There is now an extensive literature on games with one long-run player and a series of short-run players (see Fudenberg, 1992). The problem to be surmounted concerns the short run players' lack of an incentive to punish on behalf of future short run players who later will be matched with the long run player. The long run player's reputational interest in attracting participation by future short run players solves the problem: The current behaviour of the long run player affects beliefs and hence the reputation for honesty may disappear if the long run player takes present advantage of a short run player.

We can employ Kreps' trust game to illustrate the point (see Kreps, 1990). The repeated trust game can admit of multiple Players A, each of whom makes a one shot transaction with Player B. So long as the As can observe B's past transactions and B has a financial incentive to co-operate with new As in future rounds, contract will be unnecessary to sustain the co-operative relationship. Player B's incentive to preserve her reputation for in future rounds provides the necessary guarantee of performance. The game can be extended to multiple

Players B as well as multiple Players A by introducing the device of the firm. New Players B purchase interests in Firm B from departing Players B: Firm B's reputation induces investment by new Players A; new Players B have an incentive to continue to honour commitments to Players A because defection will ruin the firm's reputation and result in a loss of their investments. The firm emerges as an intangible reputation bearer, operating successfully so long as the actors making its decisions have a vested interest in its reputation.

Kreps notes that we can reach the same result – a sequence that admits new Bs and new As – with a conventional contract simply by having each new B post a bond to be forfeited in the event of abuse of trust reposed by a transacting A (see Kreps 1990). But that arrangement will depend on the costs of contracting and after the fact of enforcement. Even if *ex ante* contracting is cheap, *ex post* enforcement may not be. If it is not, the threat to go to court has no credibility. And information problems may make enforcement difficult. If honour and dishonour are observable but not verifiable, or are too expensive to verify, then contract will not induce investment. The self-enforcing arrangement, in contrast, depends on observability only (see Kreps, 1990).

Finally, we consider overlapping generations of players. Kandori has studied how co-operation can be obtained in an overlapping generation framework (see Kandori, 1992). In this model agents have a finite life, but at any given point in time there are several generations in the game. It turns out that here self-enforcing arrangements evolve with difficulty. Kandori, resorts to the device of self enforcing contractual understanding in order to get a co-operative result. He sets this 'bond' as follows: Either the older members of society are paid off by the young (assuming that everybody has behaved co-operatively so far), or, the old want to sell on their rights (i.e., their business) to the youngest (or emerging) generation. The idea that up front bonding can solve incentive problems is well known from the franchising and efficiency wage literatures.

3.4.5 Co-operation and Mixed Strategies

Another type of model which allows the identity of players to change is the random matching literature. Kandori, for example, considers a situation where agents change their partner over time, (see Kandori, 1992), with players in each stage being matched two and two using some (possibly random) matching process. For co-operation to emerge in this situation the second mode of informal enforcement must be invoked and dishonest behaviour against one partner must cause sanctions by other members of society. The model thus recalls the law merchant literature: With the Law Merchant system, norms held by the group encouraged merchants dealing with strangers to behave honestly. Here the repeated game literature reaches the same result as a formal proposition.

One might predict that the information requirements necessary to co-ordinate the social sanctions are very demanding but, as shown in Kandori, co-operation can be obtained given the following simple structure. Each agent carries a label and the necessary information is transmitted by the agents' labels. After each stage, the label is updated using only the original label and the action at this stage. This is referred to as local information processing as only local information is used. That is, the labels contain information sufficient to permit the agents to act without having to use any other information they might possess. This ensures that the equilibrium does not depend on the set of information known to the broader society. Furthermore, the equilibrium should not depend on the manner in which agents are matched nor on the number of agents. Although these are demanding requirements, Kandori proves a folk theorem in which the strategies have a particularly simple structure. Four strategies are needed. The strategies include: (1) an honest agent meeting honest agent; (2) an honest agent meeting a guilty agent; (3) a guilty agent meeting another guilty agent; (4) a guilty agent meeting an honest agent. In addition to these strategies the equilibrium requires a mechanism which updates the label. A guilty agent carries that label for T periods, and, provided that he or she does not sin again, is then restored to a label saying 'honest'.

3.4.6 Multiple Equilibria, Hierarchies and Focal Points

As noted above, in many cases in the world of repeated games there is a very large (possibly infinite) number of outcomes which are better than the non-co-operative outcome and which can be supported by some combination of promises and threats. These persistent multiple equilibria give rise to questions respecting the viability of the reputation effects model of co-operation (even as modified to allow for changing rosters of players) to provide the basis for a theory of the firm. Quite simply, the number of equilibria predicted vastly outnumber the number we would expect to observe in the real world. This creates the problem of predicting an outcome from these potential equilibria.

Some theorists have resorted to norms or conventions as a means of selecting equilibrium outcomes and solving the indeterminacy problem. One such approach is taken by Kreps as he goes about expanding the trust game into a theory of the firm. The first step in the expansion is Kreps' assertion that the trust game implies an hierarchical firm. To illustrate this point, he presents a fact pattern keyed to the distinction between observation and verification. The amount of B's future compensation depends on the nature of B' performance, and B's performance, while observable, is unverifiable. Given this, the practical result is that one of the parties will have to specify the payment amount *ex post*. It is the specification power that makes the transaction hierarchical. Significantly, the reputational model allows for such a transaction

structure absent verifiability: one party will willingly take an hierarchically inferior position – that is, an A will extend to a B a power to make a determination respecting B's performance - so long as observability can lead to punishment in the case of an opportunistic determination. The more transparent the performance the better the arrangement works; but it may go forward even with partial observability, with inefficiency creeping in as limited information makes punishment episodic.

These hierarchical arrangements, says Kreps, are also well-adapted to the treatment of unforeseen contingencies that resist contractual treatment *ex ante*: The parties may specify a procedure pursuant to which the hierarchical superior later determines a provision covering the unforeseen event, with the hierarchical inferiors relying on reputation and self-enforcement in dealing with that determination. But how will that later evaluation be evaluated, given that its character is by definition unforeseen? And how, *ex ante* can a firm communicate a commitment to later fidelity to the inferiors' interests?

Kreps at this point draws on Schelling's concept of a focal point (see Schelling, 1960) – a generally stated behavioural principle that evolves through experience on which actors can draw in reacting to new situations. Corporations, he suggests, will articulate such principles and communicate them to hierarchical inferiors *ex ante*, giving them an idea as to how the organisation will react to unforeseen contingencies. These focal point principles reduce the number of future possible equilibria by lending identity to the organisation, and even provide a means by which to measure the performance of hierarchical superiors. They constitute a 'corporate culture' that evolves over time and provide a point of friction that generates predictable outcomes. Past experience determines its shape, but its principles are redefined as unexpected events occur.

3.5 The Game Theoretic Models of Private Information and Their Implications for Corporate Legal Theory

Kreps' expansion of the repeated game models into a theory of the firm offer a picture in marked contrast with that of contractarianism. Since co-operation evolves over time in these models, emphasis shifts away from *ex ante* planning respecting future events about which actors know little or nothing to *ex post* adjustment conducted when the actors have the pertinent information. The producing actors, sceptical about both the efficiency of bargaining and the possibility of writing complete contingent claims contracts, place their activities under a centralised authority and thereby economise on the costs of contractual specifications.

But, as argued in Williamson, (1993) Kreps' model of production as spontaneous order is not outfitted for direct transportation to the legal context. A

game theoretic exercise such as this is, by definition, a stylised, assumption-laden search for equilibria that are credibly self-enforcing, undertaken without reference to contract or direct legal mandate. In practice, actual firm contracts exist in some situations, and the game theory does not suggest that informal punishment strategies are somehow intrinsically superior to them. Moreover, game theory deploys the same rational actors as does the contractarian model, bolstering the case for their self-reliant capabilities by modelling co-operative production without any state protection at all.

However the game theoretic firm need not be transferred to legal contexts on a stand alone basis. It holds a set of basic assumptions in common with the first principles approach to incomplete contracting described in section 3.3. The two approaches can be combined to provide the basis for an alternative legal theory of the firm that breaks with contractarianism. Section 3.5.1 lays out this argument, showing how the insights of the game theoretic models can be interpolated into our understanding of real world incomplete firm contracts.

But we also acknowledge that the composition and direction of the questions prompted by the game theoretic models depend to some extent on the disposition of the questioner. There is an alternative view pursuant to which these models import scepticism respecting some contractarian assumptions and techniques, but do not imply abandonment of the overall approach. For purposes of contrast, section 3.6 describes points made in some precedent and much more incrementalist corporate law applications of points from the game theoretic models.

3.5.1 Fundamental Questions About the Contractarian Firm

Although, the game theoretic model does not compel a fundamental critique of the contractarian paradigm, it does provide the basis for one. The contract model builds the firm on layers of arms length bargains actual and hypothetical. Power is transferred so as to create hierarchies, but through contractually controlled delegations: The shareholder is the principal and the manager is the agent. The incomplete contracts paradigm undercuts the base of hypothetical arms length bargains with its assertion that rational economic actors may not be able to contract their way into governance structures. The game theoretic models, having assimilated that point, build firm hierarchies on open-ended, noncontractual transfers of power: Here the manager is the hierarchical superior, and (in the finitely repeated game models) production literally follows from the possibility that trust successfully may be reposed in an honourable actor. Rational self-protection is not absent; but it manifests itself in non-contractual refusals to deal rather than in contracts.¹⁸

¹⁸ Williamson 1992 objects that Kreps' attempt to model the firm as a spontaneous

Of course these models describe a framework that completely avoids reliance on legal enforcement. Any negative implications therefore appear to lie equally against the contractarian model and the traditional legal model in which trustworthiness is imposed through fiduciary responsibility. But now let us change an assumption: Although informal punishment works in the repeated game models, in practice some sort of legal enforcement is needed. Now, given this, hypothesise that legal enforcement can be made available in only one of two forms: It can either be conditioned on actual and exhaustive contracting by the actors or can proceed under a minimal set of state-supplied legal standards. What form of legal intervention will work best, given the model?

If, as the game theoretic models assume, contracting can be neither expected nor demanded, then, as between the two, the state-supplied rules might facilitate production better (see Aghion and Hermalin, 1990). Recall that under contractarianism the law serves only to save the actors incidental costs by providing contractual provisions in advance. It assumes that absent these default provisions the actors would spend the money to create them. But if we take into account the causes of contractual incompleteness - technological limitations, private information and strategic behaviour - it becomes just as easy (and perhaps easier) to assume that this might not happen. The actors, accordingly, might prefer a few state supplied standards supplemented by noncontractual reputational enforcement over contract.¹⁹

A functional justification for the positive law firm follows directly: Since actors will not necessarily devise thorough-going contractual structures, the law should facilitate production with a handful of backstop mandates, leaving open a field for contract to the extent that the actors can manage it. The mandates protect the extension of trust by hierarchical inferiors, thereby encouraging production. The protection stems from the transfer of the non-contractual punishment function from the firm participant to the legal decision-maker (Milgrom, North and Weingast, 1990).²⁰

organization underplays the element of intentionality that distinguishes hierarchical production from market exchange. That criticism can be accepted; in fact Kreps has accepted it.

¹⁹ Arnoud Boot et al. show that financial contracts often exist when there is no legally binding obligations. In the context of loan commitment, banks supplement their reputational capital by honouring their contracts. The decision to honour or not will impact the guarantor's reputation. Boot et al. point out that it is the reputation mechanism, embodied in the form of publicly-observable formal documents, which gives banks an alternative to contract. Discretionary contracts are useful to banks in that they reveal high and low types, which offers them a basis to develop their reputation. See A. Boot, *et al.* 1993, pp. 1165-1183.

²⁰ The transfer of the punishment function to a legal decisionmaker shores up the assumptional problem with the game theoretic model. It has been suggested that relentless

The overlap between the game theoretic model and the traditional legal model, thus established, thickens with a reference to Kreps' focal points. In his model, these serve (in the absence of contract equilibria) as co-ordinating concepts on which the noncontractual firm grounds its reputation. Nothing prevents them from continuing to do so when the noncontractual firm is coupled to the legal firm: To the extent that legal enforcement is costly, the firm will remain concerned about its reputation. Given a 'legal firm', the focal points serve an additional function. They provide a practice referent on which to ground the substance of the mandate. Indeed, Kreps' focal points lend themselves to recharacterization as old-fashioned legal norms.²¹ Like traditional fiduciary standards, they come to bear in response to transfers of authority, they are directed to the expectations of dependent parties, and they are instantiated and reshaped through a process of *ex post* application.²² One point of difference should be noted, however. Kreps' focal points represent a normative regime that is completely internal to the particular firm. The norms of corporate law, in contrast, look both to the firm's internal expectational picture and broader notions about appropriate conduct that circulate in the world of firms in general. That is, they combine the Kreps' focal points with the mode of social enforcement we see in Kandori's model of randomly matched players.

Recall also that Kreps introduces focal points into his model in order to support the reputation that literally holds his noncontractual firm together. The element of functional necessity, taken together with the device's resemblance to the legal norm, suggests a challenge to the contractarian assertion that the burden of proof always lies against regulation. If firms need co-ordinating norms and contract cannot be assumed to provide them, then a global deregulatory presumption is unjustified. Consider the legal problem presented when a plaintiff asks that a new legal standard be extended to cover an unforeseen development. Under Kreps' analysis the determination presumably would be left to fact specific determination either way, rather than automatically

forward punishment in the event of a defection is not safely assumed in repeat games - in the next stage the defecting actor will request forgiveness, and future returns may make it rational to accede to the request. See, Fudenberg and Tirole, 1991. The mandate imports renegotiation proofness even if facilitates ongoing play.

²¹ Kreps acknowledges this point (see Kreps, 1990), pp. 143-145.

²² We reject the idea, advanced by Clayton Gillette, that the *ex post* discovery of the appropriate focal point is unrealistic ambition because of the high transaction costs involved and the fact that there may be too many equilibria for the court to analyze, (see Gillette, 1993). The problem with Gillette's analysis is that it relies on a first-best view of contract (ie, that the parties will be able to design the appropriate majoritarian default), and does not investigate the menu of choices available to courts in selecting a focal point.

resolved in favour of refusal to extend the standard on the ground that the dependent party 'should' have made a contract.

The challenge to the contractarian burden of proof can be restated at a more fundamental level. Recall that one function of Kreps' focal points is to provide standards to guide the firm's response to changing circumstances. But, viewed from the vantage point of a dependent investor, focal point principles cannot completely solve the problem of changed circumstances. The dependent investor remains vulnerable to drastic alterations in the game's payoff structure that transform the game from an infinite play pattern to one in which the end period is immediately foreseeable. Here, as is well known, reputation matters little to a rational actor. The sudden appearance of hostile take-overs and management buyouts of the 1980s provide an example of such a sudden shift in the terms of the game.

This possibility of a change in fundamental circumstance makes necessary a reference to the finite play models. These suggest a cost economics of investment that succeeds by abandoning the assumption that all actors are purely self-interested and introducing the possibility of honourable conduct. Of course, the modification is a limited one: An A's trust of the Players B need not be thorough-going; trust is based on a probabilistic appraisal as to type and A is ready to punish defection. Even so, the model displays a conceptual tie to the traditional mode of the fiduciary relation. It invites us to divide the world of economic interaction into two broad categories. In one category, *ex ante* contracting is cost effective and sufficiently complete to solve the problem of self-interest by providing a satisfactory guaranty of legal protection. In the other, complete contractual protection *ex ante* is not cost effective because of informational asymmetries and a long list of possible future relational problems. Complex transactions, accordingly, will depend on noncontractual enforcement techniques. But, given real world informational asymmetries and changing circumstances these are unlikely to provide a complete solution to the problem of contractual incompleteness. These transactions as a result will require an extension of trust by one or both parties; and, absent a population of honourable types, these transactions may not occur.²³ Doubts about the prevalence of honour in the population can be mitigated by a backstop regime of legal protection that enforces honour.

²³ A resemblance to Ian MacNeil's division of transactions into discrete and relational categories is noted.

3.6 Incrementalist Contractarian Applications: Default Rule Analysis

Contractarian theory asserts that corporate law's only function is to save costs by providing default rules in advance, with the terms for which a majority of parties would contract in a costless world leading to the greatest cost savings (see Easterbrook, and Fischel, 1991). The incomplete contracts paradigm, with its emphasis on informational asymmetries and recognition of the presence of multiple equilibria, rebuts the second part of this assertion. The literature articulating this rebuttal is well-developed. It moves us from a legal discourse limited to the determination of what most of parties would want in a costless world to a discourse directed to the comparative assessment of the contractual equilibria that result from alternative defaults (see Ayres, 1992). Instead of a single state-supplied corporate contract, we get menus of regulatory possibilities (see Ayres 1992). Suppletory rules that the parties would not have chosen for themselves, called 'penalty defaults', may prove to be more efficient than majoritarian defaults because they force parties to share information as they bargain around them.²⁴

Models of bargaining under asymmetric information even support unqualified legal prohibitions of certain contract terms (see Aghion and Hermalin). A third alternative, the high cost of contracting *ex ante* for unforeseen contingencies supports default rules framed along the lines of the vague standards of existing fiduciary law.

Ian Ayres, arguing the latter point, brings an openness to *ex post* consideration of the import of events to bear against contractarianism's insistence of

²⁴ Ayres and Gertner suggest the 'penalty default' in corporate gap-filling contexts. Under this, the contractarian judge departs from the hypothetical contract principle to introduce a term to which the parties would not have agreed in order to prod the party with greater information into disclosure. The function of a default rule is to supply the best possible pooling equilibrium term. The choice of penalty default depends upon the features of multiple Nash equilibria in the asymmetric model design being considered (Ayres and Gertner, 1989). Ayres and Gertner also open up the distinction between tailored and untailored suppletory rules. In the former case the judge ascertains what the parties in the case would have contracted for, a particularistic exercise. In the latter case, the judge constructs a single off the rack standard for all legal contracts. Ayres and Gertner suggest that in the particular case, the selection of the particular suppletory rules will be complex, depending on the contract cost picture and the effects of the different possible supplementing rules. Ayres' claim that penalty defaults can be extended to corporate contracts is challenged by Klausner, who argues that, due to network externalities, contracting parties may reach suboptimal bargains. Because penalty defaults may produce a wide range of responses, firms are less likely to co-ordinate their actions so as to capture network benefits. (See, Klausner, 1995, pp. 757-852).

terms based on complete allocation of risk *ex ante* (see Ayres, 1992). Since the corporation is a long-term relational contract that must cover all future states of the world, and costs prevent *ex ante* negotiation of these terms, judicial intervention *ex post* promotes efficiency by supplying the necessary terms. Fiduciary law's 'muddy' (or open ended) defaults occasion these interventions by providing for judicial determination of duties after the fact, when circumstances can be verified.²⁵ Furthermore, argues Ayres, such terms may be cost efficient even if a majority of firms would prefer clear rules that explicitly permit or prohibit stated conduct. Muddy rules of reasonableness are prohibitively expensive *ex ante* because they can be articulated only over time through judicial treatment of particular situations. Clear rules, in contrast can be stated cheaply in advance because information about the state-of-the-art file of clear legal forms is cheaply available. Forcing the majority to opt into the clear rules as it reacts to the body of judicial precedents thus saves costs overall.²⁶

Ayres' treatment is incremental and stays well clear of the traditional doctrinal theories that justify fiduciary intervention. It validates fiduciary methodology within a framework that stays with contract at the bottom line: Here *ex post* judicial intervention is legitimated only on the basis of an *ex ante* default rule that has been justified on a contractual cost-benefit analysis.²⁷ The penalty default concept works similarly. Under it, the legal rule gets its substance by reference to its effect on an assumed bargaining process insofar as it leaves terms open until relevant information is available.

Game theoretic exercises in this incrementalist mode have an indeterminate aspect. Here, game theoretic techniques work together with contractarian assumptions, and the latter can come to dominate the mix. The penalty default concept, although generally assumed to import support for protective rules,

²⁵ Ayres states that 'Muddy defaults make contractual obligations contingent on circumstances ("states of the world") that are verifiable by courts *ex post*, but prohibitively costly to identify *ex ante*.

²⁶ Carrying Ayres' point a step further, it can be argued that 'muddy' fiduciary determinations provide a useful positive law base point for the articulation of private per se rules over time. Situational judicial precedent provides information respecting changing relational contingencies. Absent this experimental data, information costs could loom larger in the drafting of clear prohibitions.

²⁷ Klausner contends that the muddy default analysis is for the most part consistent with a network externalities perspective. Muddy defaults are preferable to untailored default in that they are more likely to reduce the probability of a suboptimal uniformity. Indeed, the *ex post* tailoring of defaults is more likely to reduce network externalities for heterogeneous firms. Moreover, muddy defaults may, to the extent that new information is fed back into the customizing process, promote optimal contract networks for homogenous firms.

can be deployed to the opposite effect. Jason Johnston's model of close corporation bargaining brings this possibility into view (see Johnston, 1992). Johnston's analysis leads to a default recommendation that cuts against a protective standard that has evolved in American close corporation cases.

Johnston takes up a two party problem that recurs in disputes over fiduciary duties in close corporations.²⁸ An entrepreneur provides the financial capital and controls the corporation through majority stock ownership; a manager contributes human capital and owns a minority of the stock. If the two cooperate, returns will be maximal. But both are in positions of exposure to the other's opportunism. A bad entrepreneur will fire the manager after the manager has made a firm specific investment of labour. A bad manager will shirk and, when justifiably fired, bring a bad faith lawsuit alleging breach of fiduciary duty. The parties have to decide whether to include a term providing that the manager can be terminated only in good faith at the time of corporate organisation. The outcome of this negotiation will bear on the firm's later operation, affecting the entrepreneur's decision whether to divert firm specific assets and the manager's decision whether to make firm specific investments.

The situation, thus outlined, presents a variant of the prisoners' dilemma combined with an *ex ante* signalling game. Here both the information asymmetry and exposure to opportunism are double sided each party has an opportunity to defect and each lacks knowledge as to whether the other is an honourable or dishonourable person. The bad entrepreneur will divert the manager's investment, the good manager will make specific investments. A good faith termination term plays out differently depending on the probabilities as to type. The good faith term or fiduciary duty encourages investment by the good manager, but provides a basis for the bad manager's bad faith lawsuit. Bargaining over the term signals as to type.

Johnston's detailed analysis concludes that fiduciary protection is not efficient on most fact patterns.²⁹ Even so, bargaining should result in a protective term in many cases – a good entrepreneur can be expected to propose it as a way of signalling a trustworthy character to the manager whenever the risk of the bad faith lawsuit is tolerable. Strict limits on the implied in law duty, says Johnston, thus help good managers find good entrepreneurs. They also increase the chance that bad people will reveal their type, destabilising comparative ventures that should not get past the formation stage.

²⁸ See *Jordan v. Duff and Phelps Inc.*, 815 F. 2d 429 (7th Cir. 1987).

²⁹ In his view the situation in which a hypothetical contract case for a duty can be made out is narrow. Three factors must combine: A bad faith managerial law suit must be unlikely, managerial investment must be very sensitive to levels of legal protection, and firm specific investment by the entrepreneur must be unimportant. In all other cases the parties should be left to bargain for their own term. Johnston, 1992, p. 323.

These conclusions are reached despite the recognition that an implied in law duty would reduce rewards to bad people *ex post*. Significantly, Johnston reaches this result only after making a pair of contractarian assumptions. First, he assumes that actors are well-informed and rational and will attempt to bargain into such responsibilities as suit them at the formation stage. Second, he assumes that courts acting in litigation contexts do a bad job of determining what the parties would have wanted *ex ante*. Johnston contrasts and rejects an alternative assumption under which the parties simply trust rather than treat trustworthiness as an information problem for solution through bargaining. In such a world of probabilistic 'degenerate beliefs' in the certainty of trustworthiness, says Johnston, a legal regime with broad fiduciary duties is 'simply a shorthand for what the parties actually believed and expected'. *Ex post* interpolation of duties has no effect on *ex ante* incentives of parties modelled in this trusting mould because they do not bargain in the first place.

Thus, Johnston withholds *ex post* protection on a penalty default basis even while recognising that most parties may be trusting.³⁰ He thereby brings the penalty default device into alignment with the contractarian norm of forced bargaining. His approach must be questioned in a number of respects, however.

First, references to the incomplete contract paradigm and to the evolution of practice respecting close corporations make it possible to reverse Johnston's penalty default. Consider his assumption that parties will be rational and disposed towards contract. This does not exclude the possibility that an exhaustive contract may be prohibitively costly, even given a strategic legal stick. Nor, given past legal patterns, does a disposition to bargain by itself support a penalty default. Historically, corporate law placed the burden of protection on close corporation actors themselves. It learned to intervene on behalf of those injured in dependent positions at the same time that it learned to broaden the field for self-protective contracting. An extensive file of protective contract forms became available as a result. This evolutionary pattern makes it hard to argue that a penalty default is needed to prompt reference to the form file by actors already disposed to do so. The judicial good faith duty seems unlikely to remove their incentive to contract, given the high cost and uncertainty of enforcement.

Second, Johnston's assertion that courts do a bad job at reconstructing *ex ante* bargains should be compared with Ayres' defence of muddy defaults.

³⁰ A determining contractarian norm is implicit. Presumably, in an evolutionary context determined by the survival of the fittest, the trusting 'degenerates' will perish in time. Then, with a legal regime keyed to *ex ante* strategic problems, we will have an ideal population of good people who are also well informed two-fisted bargainers.

Following Ayres, it becomes possible to assert that the value of the courts' contribution does not turn on their relative ability to reconstruct non-existent *ex ante* bargains. Their job instead is to apply general principles to the performance pattern that emerges in history, so as to facilitate adjustments in subsequent generations of contracts.

Finally, it seems unsafe to assume that forced contracting will prompt beneficial informational exchanges as good actors seek out other good actors at the formation stage. It could be that the honourable dispositions that enhance productivity are not easily flicked off for purposes of negotiation and then flicked back on when performance starts later on. Just as a good entrepreneur signals trustworthiness by proposing a fiduciary duty, so may a good manager signal trustworthiness by waiving the opportunity to enter into a two-fisted negotiation. Moreover, the contractual matching of good types leaves unsolved the problem of unforeseen events. Fidelity to a joint and productive project is not a permanent given. Good types in long-run performance situations can stumble into misunderstandings; objectively opportunistic actions may follow, even as both actors remain sure of their own goodness. Their reciprocal commitment needs periodic modification and reconfirmation as the commercial situation changes in a dynamic environment. The more stable the environment, the better its chances for sustenance (see Frank, 1988). The legal backstop imports stability for contracting actors even as it protects more trusting types.³¹

³¹ Implied in law duty does not change the *ex ante* bargaining context. The parties must contract to opt out rather than opt in, and strategic barriers make this difficult. Presumably, the bad entrepreneur would be signalling his or her type by suggesting opting out. The good entrepreneur might be afraid of a bad type lawsuit and wish to pare down an implied duty, but be chary of sending a wrong signal as to type. But since the legal duty promotes investment, there is a compensating benefit under Johnston's model. Indeed but for the problem of the bad faith lawsuit, legal protection is an unalloyed positive. To the extent that Johnston overstates the disincentive properties of the lawsuit, there is every reason to resolve doubts in favour of fiduciary protection so long as the parties remain free to opt out.

3.7 Contrarian Possibilities: Trust, Social Norms, and A Complex Model of the Actor

Game theoretic models of co-operation have inspired a new line of social theory. This offers a behavioural description of co-operative production in which trust and rational calculation coexist and complement one another. This description, having included trust as an independent motivation, goes on to recognise that normative constraints play a role in the formation of economic institutions. And it claims to achieve this result while respecting the self-interest incentive and the power of rational expectations analysis. Thus framed, this approach inadvertently tracks the traditional model of fiduciary law.

This socio-economic theory of the firm begins with the game theoretic model of co-operation, but shifts its emphasis so as to bring the extension of trust into the centre of the description. In the retold story, one actor in the co-operative venture ends up in a dependent position, necessitating assurances against defection on the dominant actor's part (see Williams, 1988). The dominant actor's reputation, which grows from behaviour over time that reveals the actor's honourable disposition, provides this assurance. The reputation gives rise to trusting expectations respecting the dominant actor's future conduct (see Dasgupta, 1988). The trust compensates for the dependent actor's informational advantage. Without it there will be no producing relationship. But, following game theory, trust will be insufficient taken alone. Since information is incomplete and the dominant party's reputational incentives will be subject to change over time, trust will be a fragile commodity. Thus, credible sanctions for defection also must be present (see Dasgupta, 1988). Sanctions push the utility of the self-interested dominant party toward ongoing co-operation, further assuring the dependent party (see Williams 1988). As the coercive backstop becomes stronger, trust diminishes; but, with a stronger backstop, less trust will be required to sustain the relationship (see Gambetta, 1988). Given the absence of perfect coercive arrangements, trust emerges as a social lubricant that makes production and exchange possible. Since neither rationality nor contract by themselves can assure the emergence of co-operative arrangements, we should design our institutions so as to bank on trust.

The socio-economic theory then turns to the other side of the trust/honour outcome, looking to game theory to ground an assertion that social norms must be included in the description of co-operative production. Norms solve the problem presented by the repeated games' multiple equilibrium outcomes. As already noted, multiple equilibria limit game theory's explanatory power it predicts many more equilibria than we find in the real world (see Dasgupta 1988). Contractarian theory avoids this problem by assuming that competition pushes actors into first best equilibria. But that approach does not satisfy theorists who accept the point that rational norm free negotiations cannot

resolve the uncertainties of bargaining (see Elster, 1989). Game theoretic models do address the problem they produce thin co-ordinating norms, such as truth-telling and promise keeping in tit-for-tat patterns. Kreps, as we have seen, goes farther and suggests that focal points evolve to support equilibrium strategies in co-operative situations. But the focal point concept is problematic in Kreps' account since it neither shows us how a significant group of players comes to follow the focal point as a norm, nor explains what motivates the players to adhere to it (see Pettit, 1990). The social theorists jump in at this point. They expand on the 'focal point', using social norms and moral codes to fill in the missing elements in the description. Norms of reciprocity equality, and co-operation, like focal points, are points of friction that generate predictable outcomes. Since they evolve in history, the matter of derivation is dealt with exogenously (see Bicchieri, 1990).

More importantly, the norms sustain trust by lending credibility to the commitments of dominant actors. The credibility lies in the response of disapproval that follows upon deviance from the norm (see Pettit 1990). The social threat can prove to be a stronger reputational incentive than the economic threat of refusal to deal. As the game theoretic models show us, refusal to deal has serious limitations whenever the aggrieved party's economic interests lie in favour of more deals and against punishment. If continued co-operation looks profitable, they might as well forgive (see Pettit 1990). Social disapproval, in contrast, occurs automatically, without reference to the alignment of the money, and involves a wider audience.

At the bottom line, the socio-economic approach offers a picture of production in which actors draw on a range of devices to import credibility to commitments to co-operation. Some of the devices, such as precommitment, investment in bargaining, and investment in reputation, are consonant with a rational expectations description. On the other hand, there are constraints that gain their credibility from social norms (see Elster 1989). The norms often coincide with self-interest as they shape actors' conduct, but they never fully reduce to explanation in self-interested terms (see Elster 1989).

With this last point, the social-economic theory asks us to reconsider the rational actor itself. Given the need for trust and the stabilising role of norms of self-abnegation, it follows that an exclusively egoistic model of the actor suffices as a basis for explanation no better than does an exclusively altruistic model. Only a mixed model of the actor works well, a model allowing for counterpreferential choices to commit to alternatives that make actors worse off but benefit a project (see Sen, 1982).

This complex actor still may be conceived as a utility maximiser: She may derive satisfaction from counterpreferential choices, a satisfaction stemming from a balance of self-interested and social motivations. But, as Frank has argued, she has disruptive characteristics when considered in the narrower

framework of economic utility. In Frank's view, the project to reconstruct co-operative behaviour in rational, self-maximising terms runs afoul of its own assumption. It reaches an immovable emotional bloc in relational situations where actors solve contracting problems by committing themselves to future behaviour that could turn out to be against self-interest. A paradox arises in these situations the conscious pursuit of self-interest is incompatible with its attainment. Frank proposes a 'commitment model' to solve these problems: Co-operative contracting solutions have to be experienced as noninstrumental in order to work. Significantly, those directly motivated to pursue self-interest will be less successful as contracting actors than those emotionally disposed to adhere to commitments in good faith. The honourable actor offers a more credible commitment and therefore makes a more advantageous contract (see Frank, 1988). Therein lies the paradox. For the model to work, satisfaction from doing the right thing must not be premised on the fact that material gains may later follow; it must be intrinsic to the act itself. If an actor lacks the necessary motivation, material gains will not follow.

3.7.1 Conclusion: The Trust-Based Firm and the Traditional Legal Model

The incomplete contracts paradigm and the theory of repeated games together suggest a fundamental critique of the contractarian firm. With multiple equilibria and bargaining costs, they undermine the assumption that market constrains a first best equilibrium. By identifying significant bargaining costs, they counsel scepticism of global contractarian penalty defaults that seek to force contracting by denuding dependent actors of legal protection. Their alternative co-ordinating device, the noncontractual focal point, suggests that protective default rules may work well after all. Finally, their division of the world into honourable and dishonourable types invites us to drop the assumption that self-interested behaviour is inevitable.

The socio-economic gloss takes us beyond critique to an alternative model. Here the game theoretic firm is restated with emphases on a base of trust, the complexity of the actor it deploys, and the co-ordinating role of social norms. This trust-based firm has a predictive capacity in the legal context that manifestly outstrips that of the contractarian firm. In the trust-based firm, as in the legal model, self-interest and honour interplay, even though each has an aspect that negates the other. As in the legal model, neither behavioural characteristic subsumes the other so as to reach a fusion that provides a clear base for *ex ante* arrangements. With the trust-based model, we can account for the evolution of a legal system in which the same conflicts come up again and again over extended periods, and in which the decision maker serves as an *ex post* mediator. The trust-based firm's thicker description also leads to an explanation of positive law with it we can side-step the contractarian conjuring trick

that turns positive law into contract and protective norms into *ex ante* bargains.

The trust-based firm thus implies a new endorsement of traditional fiduciary theory. Business relationships that balance self-interest with honour will have a potential for instability over time. This cannot be avoided through contract, because *ex ante* welfare calculations will never adequately identify *ex post* problems of unreciprocal treatment. Given this, normative interventions under the fiduciary rubric that enforce commitment to honour another's interests play a co-ordinating role. Fiduciary moralism confirms the norms' presence in the positive law construct. The norm's transfer from business practice to the law facilitates its communication to the large numbers of actors involved in production in firms. Enforcement of the legal norm supplements the informal sanctions of social disapproval and economic refusal to deal. The functional significance of legal enforcement increases as the numbers of actors become larger and collective action problems make informal enforcement less effective. Finally, the exercise of legal enforcement will be mediative, tending towards less precise determinations based on a complex behavioural model rather than attempts to formulate more precise *ex ante* calculations. Judges will always lack information necessary for the latter exercise. Moreover, the decision as to the norm's violation may be non instrumental an attitudinal response of approval or disapproval of conduct that occurs at the moment of judgement.

Social theory and microeconomics influence the trust-based firm equally. As a result, it remains open to a range of strategies for dealing with firm hierarchies. Legal intervention is one of these. But the need to trust and rely on norms is obviated to the extent that contract succeeds. In the alternative, punishment through refusal to contract may suffice in some situations. But, in any event, the deregulatory presumption of contractarianism has no place. The trust-based model invites us to apply the inherited legal framework in new situations without the assistance of a global presumption either way.

CHAPTER 4

REGULATORY COMPETITION, REGULATORY CAPTURE, AND CORPORATE SELF-REGULATION¹

4.1 Introduction

Corporate law currently faces the problem of effectuating contractual governance in an agency system that insulates agents from market constraints.² This governance discussion focuses on possibilities for strengthening the shareholders' role in the ongoing negotiation of incomplete corporate contracts. Proponents of institutional shareholder participation have taken the lead by mapping out shareholder-driven strategies for monitoring and compensation systems that will more effectively control the costs of management influence activities within the firm.³ These strategies force proponents to confront long-standing economic and legal barriers to shareholder action.

In this Article, we carry this legal confrontation to subject matter so far largely exempted from the discussion-state corporate law and the system of incentives that forms it. More particularly, we recommend partial federal preemption of state law's allocation to management of agenda control over corporate charter amendments. We argue that this intervention will ameliorate some of the cost and incentive barriers that impede shareholder action.

This recommendation requires us to confront the theory of regulatory competition that legitimates the state system. We base our challenge to this theory on a reinspection conducted without the use of a general equilibrium

¹ This chapter appeared (with William W. Bratton) in vol. 73 *North Carolina Law Review* (1995).

² Cf Jason Scott Johnston, *The Influence of the nature of the firm on the Theory of Corporate Law*, 18 J. CORP. L. 213, 24144 (1993) (noting that contractarian firm theories that rely on market constraints provide no account of the mechanisms that will lead to long-run efficiencies) (citing Paul Milgrom & John Roberts, *Economics, Organization and Management* 192-94, 277-79 (1992)).

³ See Paul Milgrom & John Roberts, *An Economic Approach to Influence Activities in Organization*, 94 AM. J. SOC. 5154, 5156 (Supp. 1988).

lens⁴ of the internal negotiating structure that forms corporate law. This reinspection reveals that charter competition results in state laws that inhibit the negotiation of contract terms that could both alleviate problems of informational asymmetry between managers and monitors and help to realign incentives to reduce the costs of management influence.⁵ This Article depicts a self-regulatory system, composed of firms and state lawmaking institutions, in which competition among the states ensures the system's capture by corporate management influence. It then draws on political theory to provide a guide for dealing with the problem. This learning from the field of public regulation highlights the formative role that process and structure rules play in capture's amelioration. We adapt it to the private corporate governance situation and conclude that removing some of the states' mandatory process rules would create opportunities for shareholder participation in contract negotiation and for shareholder influence on the formation of state law.

Part I provides an overview of our proposal for agenda access for shareholder-proposed amendments to the firm's contract. This discussion examines the objectives and strategies of the shareholder participation movement in the context of corporate law's historic debates over governance strategies and state lawmaking systems.

Part II critically reviews the market-based justification of the charter

⁴ That is, we do not assume that competition among the states in the production of corporate law, taken alone, over time will assure the evolution of an optimal legal regime.

⁵ Cf Paul Milgrom & John Roberts, *Bargaining Costs, Influence Costs, and the Organization of Economic Activity*, in *Perspectives on Positive Political Economy* 57, 82 (James A. Alt & Kenneth A. Shepsle eds., 1990) (noting the role of distorted information in the decision-making process of central authorities). Under Milgrom and Roberts's 'influence cost' model of the firm, the firm must confront problems of informational asymmetry if it is to make and support efficient choices. The problem is that decision-makers must obtain and rely upon information generated by others. Employees and other players, by virtue of their place within the organization, possess information that could have a significant impact on decisions made by principals. Absent sufficient incentives to release these information rents, the agents will use this information to influence the decisions of those above them in the hierarchy. According to Milgrom and Roberts, the problem for an actor higher in the hierarchy attempting to monitor these agents is this asymmetric information-the asymmetry 'prevents easy determination of whether a particular observed action or outcome corresponds to desirable behavior and thus renders the problem nontrivial.' Milgrom & Roberts, *supra* note 2, at 156.

Shareholder participation strategies seek to alleviate the asymmetric information problem in the public corporation with devices such as process reforms (which take the initiative in the design of internal incentive schemes away from management) and direct placement of independent monitors in the boardroom. See *infra* notes 148-241 and accompanying text.

respects. First, it understates the effects of regulatory capture because it fails to recognize that the system does not provide shareholders with either an effective exit route, or, in the alternative, an adequate opportunity to register political demands. Second, the market perspective offers an overly simplistic picture of the incentives that determine the behavior in Delaware, the leading chartering state. In the capture model presented here, state-federal political instability emerges as a positive force that occasionally forces Delaware to confront conflicting demands of managers and shareholders and effect a somewhat more even-handed mediation between the two groups. The model also suggests caution in the selection of a legal corrective to the capture problem: Discrete federal intervention to facilitate shareholder participation in corporate contracting emerges as preferable to blanket preemption. In our view, federal preemption that institutionalizes an opportunity to register conflicting demands on state lawmakers would not sacrifice the relational advantages that flow from corporate law production in a small, market-sensitive jurisdiction.

Part III examines the theories, accomplishments, and open agenda items of the institutional shareholder movement. The discussion describes and evaluates three participatory modes: discrete issue-based voting contests, coalition-based voting for board seats, and relational investment in large share blocks. Only the first mode clearly passes the tests of cost-benefit feasibility and insusceptibility to management capture. In practice, discrete voting contests have occurred because they require low out-of-pocket costs and serve as vehicles for reputational gain by a narrow segment of institutional agents. These agents' reputational interests make them unlikely candidates for capture. At the same time, reputational interests render managers vulnerable to the institutions' dialogic activities and, therefore, prone to make concessions. Contractual modifications have resulted. The second participatory mode, coalition-based board voting, holds out the promise of high-intensity monitoring with little chance of capture due to absence of capital investment by, and reputational profiles of, the hypothesized monitors. However, federal regulation impedes experimentation, and there are substantial cost and incentive barriers. The third mode, relational investing, solves the problems of coalition-building by making the volunteer monitor a substantial equity investor. In theory, this volunteer recoups its costs as its equity block increases in value due to its input into the firm's governance. Also in theory, this volunteer's public-regarding⁶ profile renders it impervious to the free ride taken by the rest of the shareholders. Practical feasibility presents no problem in the sense that large block investments and attendant governance engagements have long

⁶ That is, activated by the interests of the shareholders as a group.

occurred in practice. However, a practical problem does follow from the magnitude of the actor's investment. Large financial stakes make sustained public-regarding relational engagements unstable. Both capture by management in exchange for separately negotiated rents and defection into the camp of a hostile offeror remain structural possibilities.

Part IV asserts that practical barriers to experimentation with the second and third modes of shareholder participation make it worthwhile to recommend federal intervention against state-mandated agenda control. This discussion details the restrictive effects of state law's agenda mandate, describes the central role of charter competition in the mandate's evolution, and proposes limited federal intervention to ensure a shareholder privilege to initiate charter amendments. We recognize that shareholder initiative could lead to rent-seeking and the emergence of voting cycles. To ameliorate the rent-seeking problem, the proposal limits access to matters of process and structure. To cut off the cycling activity, the proposal includes a set of ancillary process rules.

I. INTERNAL AND EXTERNAL GOVERNANCE STRATEGIES AND STATE CORPORATION LAW

4.2 Deterrent Governance Strategies and State Charter Competition

An unsatisfactory organizational incentive scheme hampers the performance of large corporations. Opportunistic managers often exert excessive influence over their governance mechanisms, exploiting a collective action barrier to effective monitoring by dispersed equity owners. Solving this management-shareholder agency problem is corporate law's long-standing, unperformed assignment. Historically, debate over the appropriate solution has centered on two competing deterrent strategies. The first, the 'fiduciary' strategy, is the corporate version of command and control regulation. It follows from assertions by Berle and Means that shareholders lack any effective means to monitor the firm themselves, that no adjustment of shareholder incentives will cure the problem, and that therefore the state must intervene to pick up the slack by imposing mandatory rules.⁷ Under the strict regime envisioned, process rules that provide entrepreneurial lawyers with financial incentives to enforce fiduciary norms address the shareholders' collective action problem. The competing approach, the 'market' strategy, seeks to deter management shirking

⁷ Adolf A. Berle & Gardiner C. Means, *The Modern Corporation and Private Property* 219-21, 241-52 (Harcourt, Brace & World, Inc. 1968) (1932).

by clearing the field for the operation of markets for products, management employment, and corporate control. According to this view, economic actors in free markets can be relied upon to protect themselves, and over time collective action problems solve themselves as fit competitors survive in a competitive environment. Here a different sort of entrepreneur, the hostile tender offeror or proxy contestant, plays the critical enforcement role.⁸

Most observers agree that an effective legal model must draw on both modes of deterrence, but proponents of the two strategies dispute the appropriate weighting of the legal mix. Proponents of fiduciary control question the market's effectiveness in protecting shareholders from management opportunism and see mandatory fairness norms as necessary supports for systemic confidence. Market proponents see fiduciary regulation as a barrier to the market's operation in some cases, and otherwise as an unnecessary deadweight cost, except where intervention proves necessary to facilitate the operation of free transfers of corporate control.

This debate repeats itself when attention turns to the political structure of corporate lawmaking. The federal system⁹ leaves matters of corporate organizational structure and fiduciary standards to the states; corporations remain free to choose their states of incorporation.¹⁰ Since corporate charters produce rents for the states, the states compete to attract charters. Proponents of fiduciary regulation see this regulatory competition as a 'race to the bottom': Since the managers have captured the governance mechanisms of the states' corporate customers, competition for charters by the states devolves on the provision of special benefits to managers, weakening the fiduciary regime. Therefore, a preemptive, fiduciary-based federal corporate law regime is the recommended remedy.¹¹ Market proponents counter that market controls ensure that efficient governance structures result as the states respond to the managers' demands. This 'race to the top' obviates any need for federal

⁸ Compare Frank H. Easterbrook & Daniel R. Fischel, *Corporate Control Transactions*, 91 YALE LJ. 698 passim (1982) (applying market strategy to sales of control) with Victor Brudney, *Equal Treatment of Shareholders in Corporate Distributions and Reorganization*, 71 CAL. L. REV. 1072 passim (1983) (applying fiduciary strategy to sales of control).

⁹ American corporate law has evolved with the national government assuming responsibility only for regulation of information flow in the securities markets; it imposes a mandatory disclosure regime on public corporations with a combination of administrative and entrepreneurial enforcement techniques.

¹⁰ American conflict of laws rules respect the law of a corporation's nominal domicile. See *Restatement (Second) of Conflict of Laws* § 302 (1971).

¹¹ The most prominent advocate of this view was William Cary. See William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663, 696-705 (1974).

intervention.¹²

4.3 Institutional Investor Participation and a Strategy of Enforced Self-Regulation

These debates over deterrent strategies and charter competition have been complicated in practice by two developments, one negative and the other positive. First, the negative: During the 1980s, state lawmakers took an active role in impairing the market deterrent, contributing to the collapse of takeover activity. This prompted reappraisal of the race to the top and race to the bottom views of charter competition and the emergence of an intermediate view recognizing that competition has both positive and negative effects. Next, the positive development: The collapse of the takeover market coincided with the advent of active institutional investor participation in corporate governance.¹³ This prompted the articulation of a third strategy for dealing with the agency problem: enforced self regulation.¹⁴ Under this third strategy, shareholders

¹² The most prominent advocate of this view is Ralph Winter. See Ralph W. Winter, *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251 passim (1977).

¹³ These events had profound implications for corporate legal theory. It became apparent that the theoretical resources of neoclassical economic analysis of law could not adequately describe the events taking place. The result was a renewed interest in both the politics of domestic corporate law and the comparison of foreign institutions. For discussion of the break and the shortcomings of the comparative inquiry, see Richard M. Buxbaum, *Comparative Aspects of Institutional Investment and Corporate Governance*, in *Institutional Investors and Corporate Governance* 3 passim (Theodor Baums et al. eds., 1994).

¹⁴ IAN AYRES & JOHN BRAITHWAITE, *RESPONSIVE REGULATION: TRANSCENDING THE DEREGULATION DEBATE* 101-04 (1992). Ayres and Braithwaite distinguish between 'enforced self regulation' and 'coregulation' in administrative law. *Id.* at 102. Under the former, the state and the regulated firm negotiate over standards tailored to the firm. The latter, which prevails in the U.S. securities industry, involves self regulation by an industry association with some oversight or ratification by the government. Ayres and Braithwaite explore possibilities for enforced self-regulation on the theory that the subcontracting of the regulatory function to private actors under ultimate government supervision could lead to greater flexibility in the formulation of the terms of regulation and effectiveness of enforcement. *Id.* at 102-32.

We think the concept usefully describes the mode of corporate governance envisioned by proponents of participation by institutional investors. The context is different, of course. Here the enforcing actor is not a government agency but the firm's shareholders; no immediately available sovereign mandate skews bargaining positions when the parties negotiate over governance terms. Thus we do not employ the self-regulation concept to import a 'public' coloration into a 'private' contractual matter. However, we do take the

can avoid the need to rely on legal and market deterrents to the extent that they effectively negotiate the corporate contract themselves and monitor its performance.

Self-regulatory strategies are not new to corporate governance. Indeed, self-regulation by means of a legally mandated shareholder vote for the board of directors is the system's historic base point. Commentators have debated plans to improve this self-regulatory structure's performance for decades. However, since those earlier proposals all followed from the Berle and Means assumptions, no one expected that independent internal monitors could be imposed on management by unilateral shareholder directive. Instead, the proponents sought voluntary acceptance by management of oversight by independent directors and pursued a dialogic implementation strategy. The proponents advocated a norm of majority independent board membership and attempted to have such a requirement inserted into the canon of proper business practices.¹⁵ Success was achieved in form but not in substance: The norm found its way into the canon only to be subverted in practice by management influence. By the end of the 1980s, almost three-quarters of American directors were outsiders; management nevertheless retained control of the selection process, and sixty-three percent of the outside directors selected were chief executive officers of other public companies.¹⁶

position that state mandates are already inextricably bound up in the determination of the potential scope of enforced self-regulation by shareholders and that their readjustment is an appropriate subject matter for corporate law reform.

¹⁵ Mandatory independent board structure was proposed in the first draft of the American Law Institute's Corporate Governance Project, but was cut back to precatory status in later versions at the insistence of management representatives. Compare *Principals of Corporate Governance and Structure: Restatement and Recommendations* § 3.03 (Tentative Draft No. 1, 1982) (proposing mandatory majority of independent directors) with 1 *Principals of Corporate Governance: Analysis and Recommendations* § 3A.01 (1994) (recommending majority of independent directors as practice suggestion); see also Melvin A. Eisenberg, *The Structure of the Corporation: a Legal Analysis* 17-85 (1976) (recommending mandate). For a review of the politics of the ALI Corporate Governance Project proceedings, see Jonathan R. Macey, *The Transformation of the American Law Institute*, 61 GEO. WASH. L. REV. 1212 passim (1993).

Proponents of both fiduciary and market deterrence strategies took a dim view of mandatory independent boards. Compare Victor Brudney, *The Independent Director-Heavenly City or Potemkin Village*, 95 HARV. L. REV. 597, 609-12 (1982) (emphasizing that the directors' duty of vigilance would be constrained by their need to interact with other directors) with Daniel R. Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259, 1280-86 (1982) (arguing that use of independent directors is detrimental to profit maximization).

¹⁶ Jay W. Lorsch & Elizabeth Maciver, *Pawns or Potentates: The Reality of America's*

Institutional investor participation changes this picture, holding out a prospect of self-regulation enforced by the shareholders themselves. The theory posits that concentrated institutional equity ownership¹⁷ makes joint shareholder action cost effective.¹⁸ Practice has begun to validate the theory's prediction, as institutional shareholders have used their voting power to get results. Successful publicity and issue-based proxy campaigns against underperforming companies have prompted management concessions on governance provisions, and in the most dramatic cases, boardroom shakeups.¹⁹ Theorists, however, ask for more thoroughgoing engagements than these discrete and relatively inexpensive exercises can provide. They have mapped strategies for sustained relationships between managers and institutional monitors, looking to the use of institutional votes to nominate and elect expert outside monitors, and the placement of substantial blocks of shares with public-regarding institutional owners. These more ambitious and costly proposals have not yet been tested in practice.

Shareholder participation strategies are an attractive alternative to the two deterrent strategies. The payoff for costly action by shareholder volunteers comes from improved investment policy and day-to-day management. This expands on the payoff of the fiduciary deterrent and promises governance benefits formerly in the market's exclusive preserve. Corporate law's duty of loyalty focuses on a limited class of moral hazard²⁰ problems; its duty of care avoids inquiry into the adverse selection²¹ problems that lead to unsuccessful

Corporate Boards 17-18 (1989).

¹⁷ This proportion passed 50% during the 1980s. See *Center for Law & Econ. Studies, Institutional Investors and Capital Markets: 1991 Update*, *Colum. Institutional Investor Project*, at Table 19 (1991).

¹⁸ See *infra* notes 154-58 and accompanying text. For an excellent review of the proposals on the table, see Aleta G. Estreicher, *Beyond Agency Costs: Managing the Corporation for the Long Term*, 45 *RUTGERS L. REV.* 513, 593-612 (1993).

¹⁹ See *infra* notes 162-80 and accompanying text.

²⁰ Milgrom and Roberts define moral hazard in terms of 'postcontractual opportunism that arises when actions required or desired under the contract are not freely observable.' See Milgrom & Roberts, *supra* note 1, at 167; see also Ian Ayres & Peter Cramton, *Relational Investing and Agency Theory*, 15 *CARDOZO L. REV.* 1033, 1044 (1994) (suggesting that moral hazard 'stems from the agent's "hidden action"'). This framework can be used to describe corporate law's garden variety conflict of interest transaction: A board with insufficient information respecting incentives is more likely to approve one-sided deals; rationally apathetic shareholders will take no action in response.

²¹ Milgrom and Roberts define adverse selection in terms of the kind of postcontractual opportunism that arises when one party to a bargain has private information about something that affects the other's net benefit from the contract and when only those whose private information implies that the contract will be especially disadvantageous for the other party

business plans. This limited scope follows from limited enforcement resources: Judges intervening *ex post* can untangle conflict-of-interest transactions and structure remedies, but informational complexities put investments and operations outside their competence.²² The takeover, in contrast, addresses all of these agency problems and, at least in theory, creates value for shareholders through their elimination. However, its widespread employment during the 1980s gave rise to a perceived problem of perverse effects. It appeared that prospects for short-term gain could induce the takeover of a well-managed firm, thereby chilling productive long-term investment. It also appeared that readily available debt financing could lead to speculative overbidding and subsequent bankruptcy costs.

Shareholder participation strategies promise to avoid these problems. They seek a competency payoff by placing effective monitors inside the firm. There, with access to the full set of information, the monitors will effect necessary changes through cooperation and persuasion. The deterrent strategies, in contrast, lead to punishment payoffs. The more widespread their use, the more a management subculture of resistance to outside regulation becomes entrenched.²³

to agree to the contract. Milgrom & Roberts, *supra* note 1, at 595. In this context, adverse selection stems from the agent's hidden information. A board with inadequate information cannot fully evaluate the agent's capabilities and performance, making it difficult to ensure the selection of the most able agents. See Ayres & Cramton, *supra* note 19, at 1044.

More generally, fiduciary law is ill-suited to the control of managers' influence activities that have negative consequences for the firm. In the Milgrom and Roberts model, influence activity is the time and effort spent by rational, self-interested actors in firms to influence decisions. Some of this activity may benefit the firm, but it also results in questionable pay increases, unnecessarily large budgets, acceptance of suboptimal projects and proposals, and rejection of worthwhile proposals. See Milgrom & Roberts, *supra* note 2, at 5155-56.

²² This limitation of scope, embodied in the business judgment rule, stems from a recognition of informational constraints on the process of judicial enforcement. The risk-return calculations

prevailing at the time of initial investment cannot be reconstructed *ex post*; the fact of failure invites the ascription of incompetence to conduct better described as considered risk-taking. Aggressive fiduciary inquiry into investment policy would over-deter risky investment. The corporate duty of care, accordingly, strikes only at extreme cases of incompetence. See *Joy v. North*, 692 F.2d 880, 885-86 (2d Cir. 1982), cert. denied, 460 U.S. 1051(1983); *Barnes v. Andrews*, 298 F. 614, 615 (S.D.N.Y. 1924). The Delaware Supreme Court has created an exception by strictly Scrutinizing the process employed in the boardroom of the acquired firm in a friendly merger. See *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 368 (Del. 1993); *Smith v. Van Gorkom*, 488 A.2d 858, 893 (Del. 1985).

²³ See Ayres & Braithwaite, *supra* note 13, at 19-20. The participation strategy also looks

This picture of productive relational engagement by shareholders is still largely aspirational. So far, institutional victories in discrete engagements have followed from the efforts of agents of public pension funds. These actors take the role of political entrepreneurs and act from motivations more reputational than financial. Although agents of private pension funds, mutual funds, banks, and insurance companies control the overwhelming portion of institutional equity holdings, they have not emerged as leading players in the game.²⁴ It remains unclear whether concrete cash payoffs can be realized from the loose cost-benefit projections that support the relational strategies.

A number of sticking points impede testing of the relational models. First, no one has devised an incentive scheme that integrates investment in governance participation with the range of agency arrangements that obtain in the different investment institutions.²⁵ Second, substantial legal impediments to shareholder collective action remain on the books. Early pressure for reform has resulted in some significant changes-paternalistic barriers to coordinated institutional action in issue contests have been removed from the federal proxy rules, but full-scale testing of relational models of shareholder participation awaits the implementation of a broader program to curtail the scope of the federal securities laws.²⁶ Third, a nascent incentive problem lies unresolved in the interplay between self-regulation by shareholders and market deterrence by takeover. The institutional participation movement has proceeded during a cyclical low in merger and acquisition activity. An upturn in the merger cycle and resurgence of hostile activity²⁷ would reweight the institutions'

reasonable in a loose comparative cost survey. The institutional volunteers do, of course, incur the up-front costs of campaigning, coalition building, or direct investment. That investment does not occur, however, absent the prospect of a greater performance payoff, and that payoff ultimately benefits the shareholders as a group. Meanwhile, significant costs attending the deterrent strategies are avoided. Fiduciary law carries the deadweight cost of corporate subsidy of hostile, labor-intensive judicial processes even in the meritorious case, and additional costs from unmeritorious cases stemming from the unsolved problem of process incentives to plaintiffs' lawyers to hold up firms for quick settlements. Takeovers, although said to create shareholder value overall, see, e.g., Roberta Romano, *A Guide to Takeovers: Theory, Evidence, and Regulation*, 9 *YALE J. ON REG.* 119, 152-54 (1992), do not necessarily benefit the shareholders of the acquiring firm. see, e.g., Bernard S. Black, *Bidder Overpayment in Takeovers*, 41 *STAN. L. REV.* 597, 61-15 (1989); Richard Roll, *The Hubris Hypothesis of Corporate Takeovers*, 59 *J. BUS.* 197 passim (1986), and entail enormous transaction costs.

²⁴ See *infra* notes 198-208 and accompanying text.

²⁵ See *infra* notes 229-40 and accompanying text.

²⁶ See *infra* note 244 and accompanying text.

²⁷ An upturn in the merger cycle has occurred during the last two years, but hostile takeover activity remains sporadic. See *infra* note 236.

payoff pattern away from patient engagement in favor of defection and short-term gain. That, in turn, would diminish management's incentive to cooperate.²⁸

4.4 A Federally Mandated Privilege of Shareholder Initiative

Recent commentaries on shareholder participation focus on barriers to the realization of the full relational models. This Article, in contrast, examines the legal landscape that channels discrete institutional interventions and explores possibilities for expanding the menu of contractual reforms attainable through shareholder initiative. In so doing, it constructs a theoretical case for a reform proposal made in passing many times in the past:²⁹ federal preemption of state law's allocation to management of an exclusive privilege to initiate corporate charter amendments. We revive this proposal with two consequences in mind. First, recent institutional accomplishments suggest that levelling of the state law playing field could lead to patterns of corporate contracting that begin to resemble those resulting between actors at arms' length. Second, the combination of institutional leadership and shareholder access to the charter could invigorate the charter market. Given a path for the effective registration of

²⁸ At the same time, new incentives to defect to the management side would arise in a case in which the shareholder volunteer holds a substantial block of stock and state fiduciary law proves incapable of policing a side deal. See *infra* notes 232-40 and accompanying text.

²⁹ See, e.g., Bernard S. Black, *Is Corporate Law Trivial?: A Political and Economic Analysis*, 84 NW. U. L. REV. 542, 582 (1990) (proposing a federal requirement for public companies that a majority of shareholders elect to be governed by changes in state law that affect the division of power between management and shareholders); Cary, *supra* note 10, at 701-03; John C. Coffee, Jr., *The Future of Corporate Federalism: State Competition and the New Trend Toward De Facto Federal Minimum Standards*, 8 CARDOZO L. REV. 759, 77-77 (1987) (proposing shareholder initiative by the use of proxy statement to opt out of state rules, amend the charter and change the state of incorporation); see also SEC Concept Release on Takeovers and Contests for Corporate Control, Exchange Act Release No. 3-23486, 51 Fed. Reg. 28,096, 28,100-02 (1986) (suggesting self-governance exemptions to specific tender offer rules); SEC Advisory Committee Report on Tender Offers, Fed. Sec. L. Rep. (CCH), Special Report No. 1028, at 37A1 (July 8, 1983) (recommending annual shareholder advisory votes on golden parachutes, standstill agreements, and supermajority and disenfranchising charter provisions); cf Roberta Romano, *The Genius of American Corporate Law* 83-84 (1993) [hereinafter Romano, *Genius of Corporate Law*] (proposing change of statutory defaults from opt-out to opt-in at the state level); Jonathan R. Macey, *Administrative Agency Obsolescence and Interest Group Formation: A Case Study of the SEC at Sixty*, 15 CARDOZO L. REV. 909, 944 (1994) (proposing that Congress should preempt state antitakeover statutes, leaving shareholders to make decisions respecting takeover defenses).

shareholder demands, states would have an incentive to take shareholder preferences into account in the construction of corporate law's mandatory provisions.

It is possible that rent-seeking by shareholder coalition-builders could lead to perverse effects if an access mandate were extended to matters of investment and other business decisions.³⁰ Our goals are modest, however, and their satisfaction does not require unlimited shareholder access. Accordingly, we would limit the subject matter scope of mandatory shareholder access to charter terms bearing on governance process and structure. To prompt the reorientation of the political calculations of state lawmakers, our operative concept of permitted amendments would extend to the decision as to state of incorporation.

This proposal also has a theoretical goal. The program to restructure corporate law to accommodate the economic possibility of shareholder-enforced self-regulation implies the adjustment of prevailing notions of corporate federalism. An inconsistency has developed in the commentary. On the one hand, no one questions that state law's grant of control of the corporate voting agenda to management restricts shareholder enforcement opportunities.³¹ On the other hand, the law reform movement tends to press against only the federal side of a two-sided system, foregoing consideration of the state law (and federalism) implications of shareholder participation strategies.³² This imbalance is surprising given the consensus view that the competition-driven state system imposed excessive constraints on the Operation of the market deterrent during the 1980s.

Two explanations for the imbalance suggest themselves, one practical, the other theoretical. First, proponents of shareholder participation formulate their agenda with the urgency of activists, either selecting immediately attainable improvements³³ or confronting unavoidable barriers to full realization. Char-

³⁰ On this point we follow Jeffrey N. Gordon, *Shareholder Initiative: A Social Choice and Game Theoretic Approach to Corporate Law*, 60 U. CIN. L. REV. 347, 376-81 (1991) [hereinafter Gordon, *Shareholder Initiative*].

³¹ See, e.g., Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811, 825-26 (1992) [hereinafter Black, *Agents*].

³² The exception is Gordon, *Shareholder Initiative*, *supra* note 29, at 357-59, which concludes that the system confirms the prediction of the market efficiency story.

³³ See John C. Coffee, Jr., *The SEC and the Institutional Investor: A Half-Time Report*, 15 CARDOZO L. REV. 837, 900-02 (1994) [hereinafter Coffee, *Half-Time Report*] (suggesting implementation by SEC rulemaking); Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863, 865, 883-84 (1991) [hereinafter Gilson & Kraakman, *Institutional Agenda*] (proposing institutional board monitors by means of shareholder self-help); Joseph A. Grundfest, *Just*

ter access for process and structure amendments fits neither profile. The complicated politics of federal intervention give it a low rank on the feasibility list,³⁴ and, in any event, access promises incremental rather than fundamental improvement in the agency relationship. Second, conceptual barriers impede reappraisal of the regulatory allocation between national and state governments. The reform agenda reflects the view that shareholder-enforced self-regulation is perversely impeded by federal regulations promulgated long ago by actors under the influence of Berle and Means.³⁵ Historically, suggestions for federal preemption have followed from the same, discredited³⁶ set of assumptions. More recent arguments for federal preemption have taken steps to cure this infirmity by bringing to bear both a relational contract perspective and the economic presuppositions of the market deterrent approach.³⁷ However, the cure is incomplete because these new calls for preemption continue to include the Berle and Means remedy of a state-mandated fiduciary deterrent.³⁸ Still unaddressed is the central federalism concern that federal intervention imports a risk of blanket preemption that destroys the responsive benefits of jurisdictional competition.³⁹ As a result, the market competition model of state law still carries sufficient validating force to discourage consideration of structural adjustments.⁴⁰

The federalism discussion should be disaggregated and the benefits and burdens evaluated in light of the regulatory strategy that informs a specific proposal for intervention. That step accomplished, a powerful case emerges for minimal intervention to increase the menu of subjects for shareholder

Vote No: A Minimalist Strategy for Dealing with Barbarians Inside the Gates, 45 STAN. L. REV. 857, 903-08 (1993) (recommending purely dialogic strategy).

³⁴ See Romano, *Genius of Corporate Law*, supra note 28, at 50, 75-54.

³⁵ Or, more generally, it follows from early twentieth century populism. See, e.g., Mark J. Roe, A Political Theory of American Corporate Finance, 91 COLUM. L. REV. 10, 32-45 (1991).

³⁶ Here we speak from the point of view of others. In our view, the Berle and Means description may or may not carry force in the future, depending on the success of the shareholder participation movement.

³⁷ See Lucian Arye Bebchuk, Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law, 105 HARV. L. REV. 1435, 1458-67 (1992); David Charny, Competition Among Jurisdictions in Formulating Corporate Law Rules: An American Perspective on the 'Race to the Bottom' in the European Communities, 32 HARV. INT'L L.J. 423, 442-53 (1991).

³⁸ See Bebchuk, supra note 36, at 1500-07.

³⁹ Romano, *Genius of Corporate Law*, supra note 28, at 82-83.

⁴⁰ For a manifestation of this thinking in a federal lawmaking context, see S. REP. NO. 265, 100th Cong., 1st Sess. 46 (1987) (observing that state corporate laws work well and that Congress has always decided against federalization).

initiative. The recent, unprecedented success of the shareholder activists invites re-examination of legal restrictions on shareholder-voice for the first time since the restrictions appeared in state law a century ago.⁴¹ The charter competition system prevents states from undertaking this review because it effects the capture of state lawmakers by management interests. There is, of course, nothing intrinsically unacceptable about a captured sovereign, as the political theory undergirding the market justification of the system teaches. Nevertheless, nothing in that theory also dictates the conclusion that this particular situation of capture enhances economic welfare. Previously, that conclusion was reached only on two assumptions: market constraints in any event cure the capture's negative effects; and state-mandated agenda control is irrelevant because collective-action constraints prevent shareholders from availing themselves of an opportunity to voice preferences internally. Neither assumption is safe today; state lawmakers undercut the first during the 1980s, and institutional shareholders thereafter rendered the second obsolete.

Thus, the legal terms that perpetuate the one-sided capture of state law need no longer be accepted as the best available, provided that the proposed adjustment makes both the captured sovereign and the regulated firm more responsive to the excluded shareholder interest. However, any proposed federal adjustment also must leave unimpaired such benefits of responsiveness to the preferences of actors in economic organizations as the state system does provide. The minimal intervention suggested here meets that burden.⁴²

More broadly, a strictly market-based theory of regulatory competition provides an inadequate framework for appraising the law's role in facilitating effective organizational incentive schemes.⁴³ The market-based model under-

⁴¹ See *infra* notes 275-83 and accompanying text.

⁴² To keep the discussion manageable, we avoid mentioning the problem of constituency participation. We acknowledge, however, that this corporate governance problem is closely related to that of shareholder access and ultimately must be confronted as corporate law evolves to accommodate institutional investor initiatives. Accordingly, our focus on the shareholder interest should not be taken to presuppose adherence to the shareholder primacy norm implicit in much of the governance literature. Richard M. Buxbaum, *Institutional Owners and Corporate Managers: A Comparative Perspective*, 57 *BROOK. L. REV.* 1, 41 (1991), notes that institutionalized labor-management cooperation along European lines need not be a zero-sum game, and we agree. We also think that Buxbaum, *id.* at 42A5, plausibly looks to governance innovations stemming from institutional initiatives as a potential beginning point in the evolution of American analogues to codetermination.

⁴³ Such schemes allow opportunistic actors to overcome collective action problems in pursuit of the gains of trade, promoting mutual compliance & post and allowing for credible commitments & ante. See Terry M. Moe, *Politics and the Theory of Organization*, 7 *J.L. ECON. & ORGS.* 106, 122 (Special Issue 1991).

states the distortions that result from the interplay of multiple sovereigns and interest groups in the resolution of corporate commitment, information, and enforcement problems. These problems stem in part from the capture of a sovereign mandate by one contracting group and in part from the absence of a contractual avenue for realignment of the sovereign's incentives by the competing group. This mixed problem of economics and politics calls for a mixed political and economic solution. Ideally, the political solution should be shaped to leave the ultimate resolution of the corporate agency problems to the economic actors themselves, and leave sovereign actors with incentives to make balanced responses when their preferences conflict. Federal intervention would facilitate that result if it refrained from displacing the states' role in corporate law creation and instead realigned the positions of the three parties to the corporate contract-management, shareholders, and state government-to allocate shareholders a seat at the bargaining table.

II. CORPORATE CHARTER COMPETITION AND THE PROBLEMS OF REGULATORY CAPTURE AND REGULATORY RESPONSIVENESS

This part of the Article reconsiders the debate between critics and proponents of charter competition and proposes a modified description of the system. From the critics' perspective, the charter market facilitates managerial capture of state lawmakers and prevents the evolution of an effective fiduciary deterrent. The proponents, in contrast, applaud market impediments to the development of fiduciary controls and describe a mechanism that assures state responsiveness to the preferences of economic actors. We assert that neither position remains viable in the present environment. The critics tend to overstate the problem: Capture, taken alone, does not delegitimize a regulatory regime. They also tend to overplay the solution: By displacing Delaware courts from their position as corporate law's leading center of dispute resolution, mandatory federal fiduciary standards would impair and possibly terminate the operation of a useful repository of information and expertise. The proponents tend to understate the problem: They describe a relational contract without fully exploring its political and process characteristics. This relational contract contains not only normative mandates, but also process mandates that govern the alteration of default terms. Furthermore, the capture of the mandating sovereign by one of the parties has prevented the evolution of both optimal mandates and effective ground rules for opting out. The proponents also tend to avoid sustained consideration of solutions: The federal mandate can be directed to the process side, not only to level the playing field for corporate contracting, but also to destabilize a structure that affords the states the comfort of having to respond to the demands of only one affected interest group.

4.5 The Corrupt Sovereign Versus the Responsive Sovereign

The original case for federal intervention against state charter competition combined a public interest theory of regulation with a fiduciary strategy for improving corporate law. Professor William L. Cary's leading article denounced Delaware, the leading corporate domicile,⁴⁴ as a corrupt sovereign. He undertook a general review of its courts' pronouncements and concluded that there appeared to be 'no public policy left in Delaware corporate law other than the objective of raising revenue.'⁴⁵ To Cary, the 'public policy' at stake was the integrity of corporate managers, and the revenue objective had led a single state to 'grant management unilateral control untrammelled by other interests,'⁴⁶ thereby sacrificing the national interest. He looked to federal intervention to eliminate the firms' incentives to incorporate in Delaware.⁴⁷

Cary assumed that regulation could and should pursue a notion of the general good. By the time he published his thesis in 1974, however, that theory of regulation had already fallen from favor in the social sciences⁴⁸ and was replaced by capture theories of regulation.⁴⁹ Capture theories described regulation as an arena in which special interests compete to use government power for advantage. They also debunked the public interest story of regulatory motivation—now regulators should be expected to behave no differently than actors in private economic relations.⁵⁰ This shift in political theory, coupled with the emerging market deterrent view of corporate law, permitted Cary's

⁴⁴ Delaware is home to one-half of the largest American corporations, and is the new domicile of 80% of reincorporating firms. Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. ECON. & ORGS. 225, 244 (1985) [hereinafter Romano, *Law as Product*].

⁴⁵ Cary, *supra* note 10, at 684.

⁴⁶ *Id.* at 698.

⁴⁷ *Id.* at 702. His proposal included not only federal fiduciary standards, but shareholder access to the charter and by-laws, the abolition of nonvoting shares, and mandatory indemnification rules. *Id.*

⁴⁸ See Michael E. Levine & Jennifer L. Forrence, *Regulatory Capture, Public Interest, and the Public Agenda Toward a Synthesis*, 6 J.L. ECON. & ORGS. 167, 167 (1990).

⁴⁹ Mancur Olson attacked the optimistic public interest orthodoxy of American political science as built on a misguided conception of the logic of group action. Mancur Olson, jr., *The Logic of Collective Action: Public Goods and the Theory of Groups* 16-22, 117-31 (1965). Olson claimed that the liberal view that groups formed organizations based on common goals ignored free riding by members of the group. *Id.* at 15-16. Since most of the gains from group formation could be captured by all, there was very little incentive for groups to organize. *Id.* at 1-16.

⁵⁰ Levine & Forrence, *supra* note 47, at 168-69.

race to the bottom to be reversed into a race to the top.⁵¹

The 'race to the top' story drew on the central assertion of regulatory competition theory—that jurisdictional competition ameliorates the distortions that result as interest groups compete for, and win, political favors. Under this theory, competition for domiciliaries leads to the matching of government policies with diverse citizen preferences, and thus fosters innovation.⁵² Citizens signal their preferences respecting legal goods and services when they migrate from regime to regime. Their ability to exit disempowers government actors, whose welfare diminishes as citizens depart, taking with them votes and revenues.⁵³ Given competition, law production goes forward without losing time on the task of reconciling competing preferences. The theory also implies a preference for state over national lawmaking. Since the revenue enhancement constraint on the national government is less intense,⁵⁴ the national lawmaking process will be slower, less responsive to productive concerns, and more susceptible to the influence of organized interest groups.⁵⁵

Regulatory competition theory applies to corporate law on the assumption that state corporation codes may be viewed as products consumed by corporations.⁵⁶ In the resulting description, competition for the legal business of firms forces the states to adapt the law to the dynamic conditions in which the firms operate.⁵⁷ State lawmaking emerges as a trial and error process suited to the accurate identification of optimal corporate arrangements.⁵⁸

Reincorporating firms are this market's marginal consumers. They seek a predictable legal regime that reduces their costs. Delaware provides this with

⁵¹ See Winter, *supra* note 11, at 254-2.

⁵² See Romano, *Genius of Corporate Law*, *supra* note 28, at -6.

⁵³ See Ronald J. Daniels, Should Provinces Compete? The Case for a Competitive Corporate Law Market, 36 MCGILL L.J. 130, 142A3 (1991).

⁵⁴ Romano, *Genius of Corporate Law*, *supra* note 28, at -6, 48-51.

⁵⁵ *Id.* at 5. In a federal system, the allocation of lawmaking power to the competing states also protects individuals from the power of the national government; private organizations provide an additional check by counterbalancing the power of state governments. National regulation of corporations would impair this corporate function and thus detract from individual liberty. See Roberta Romano, The State Competition Debate in Corporate Law, 8 CARDOZO L. REV. 709, 753 n.97 (1987).

⁵⁶ Romano, *Genius of Corporate Law*, *supra* note 28, at 6.

⁵⁷ Delaware, the leading corporate law state, excels in this process. *Id.* at 9.

⁵⁸ Romano's study of the spread of innovation in corporation codes found that innovations spread rapidly in a pattern resembling the S-shaped diffusion curve of technological innovations. Romano, *Law as Product*, *supra* note 43, at 234-35. Her study of state responsiveness, *id.* at 237-40, found that the more responsive states gain more and lose fewer incorporations, and that state responsiveness bears a significant positive correlation to the proportion of state revenues derived from franchise taxes, *id.*

comprehensive case law, well-specified indemnification rules, and an expert judiciary.⁵⁹ The firms also seek a guaranty that the new state of domicile will maintain the desirability of its code, because the reincorporating firm and the target jurisdiction enter into a relational contract that entails a risk of opportunistic breach. Even as the firm invests to gain access to the target's favorable legal regime, the target remains free to change its politics and transform itself into an unresponsive jurisdiction.⁶⁰ The competitive jurisdiction has to reduce this possibility by offering a credible commitment. Delaware's commitment stems from its dependence on franchise tax revenues.⁶¹ These revenues are an 'intangible asset' that emerges from the combination of a large number of incorporations and a small population. Delaware also invests in real assets specific to its incorporation business—its case law and its judicial and administrative expertise. These, together with Delaware's code, constitute reputational capital. Delaware protects this storehouse of capital by imposing internal process and structure rules that deter political disruption.⁶² This store of capital bolsters the state's market position. Other states cannot credibly precommit to offer superior service, and thus are deterred from incurring the necessary start-up costs. A first-mover advantage in Delaware results.⁶³

⁵⁹ Romano, *Genius of Corporate Law*, supra note 28, at 32-40. Romano has backed this cost-reduction assertion with a study of public corporation domicile changes between 1970 and 1982. See Romano, *Law as Product*, supra note 43, at 242. The study shows that corporations tend to change domiciles in advance of either a public offering, an acquisitions program, or the promulgation of antitakeover measures. *Id.* at 250. They incur substantial costs in so doing, including the one-time costs of the move, the possibility of appraisal claims, and, in the case of corporations moving to Delaware, the present negative value of an additional layer of high franchise taxes. Romano, *Genius of Corporate Law*, supra note 28, at 3-35. The benefits mostly stem from the threat of litigation—all three of the identified transactional occasions for changes of domicile entail litigation risks.

⁶⁰ New Jersey did this early in the twentieth century, precipitating a mass movement of corporations across the river to Delaware. Joel Seligman, *A Brief History of Delaware's General Corporation Law of 1899*, 1 DEL. J. CORP. L. 249, 265-70 (1976).

⁶¹ Romano, *Genius of Corporate Law*, supra note 28, at 38-39. Franchise taxes amounted to 17.7% of Delaware's total tax revenues in 1990. *Id.* at 10.

⁶² These include its direction of corporate matters to a specialized chancery court, its practice of appointing rather than electing its judges and limiting them to 12-year terms, and its requirement of two-thirds majorities in both houses of its legislature for the approval of corporation code amendments. *Id.* at 3842.

⁶³ *Id.* at 4044. The store of capital also fosters reciprocal dependencies between Delaware and its customers. The lawyers who recommend reincorporation to client corporations invest in Delaware expertise, and thus have incentives to recommend it as a destination. Their clients need to economize on legal costs, and thus tend to stay in place. For competing

As originally articulated, this market-based race to the top validation of state law bypassed the problem of the shareholders' lack of influence over state lawmaking with a reference to the control market deterrent. The assertion, in effect, was that the managers' option of exit adequately disciplined the states, while the possibility of shareholder exit by tender to a hostile offeror adequately disciplined the managers. This story lost its persuasiveness as managers and state politicians collaborated⁶⁴ to hamper the market deterrent with the anti-takeover legislation of the 1980s⁶⁵ This manifest case of charter market fail-

explanations, see Richard A. Posner & Kenneth E. Scott, *Economics of Corporation Law and Securities Regulation* 111(1980) (finding that large firms go to Delaware); Barry D. Baysinger & Henry N. Butler, *The Role of Corporate Law in the Theory of the Firm*, 28 J.L. & ECON. 179, 190 (1985) (finding that firms with concentrated ownership do not go to Delaware).

The basic model of the 'first-mover advantage' is that of Michael Spence. See Michael A. Spence, *Entry, Capacity, Investment and Oligopolistic Pricing*, 8 BELL J. ECON. 534, 534-44 (1977). Under it, an oligopolist must commit resources to a certain level of production; a potential entrant can observe this, and must decide whether to enter and produce at a certain level. *Id.* at 534. Spence's entry deterrence model assumes a two stage game in which one firm may enjoy a first-mover advantage if it can choose its quantity first: Because firm one uses its excess capacity to deter firm two's entry, quantity has a commitment value. *Id.*; see also Jean Tirole, *The Theory of Industrial Organization* 317-22 (1988) (reviewing the Spence-Dixit model and interpreting it as a double capacity game, 'with production as the first capacity constraint and selling capacity as the second'); Avinash Dixit, *A Model of Duopoly Suggesting a Theory of Entry Barriers*, 10 BELL J. ECON. 20, 20-32 (1979) (finding that 'a great absolute advantage in demand (or cost) for established firms makes entry harder but lower cross-price effects with potential entrants' products make entry easier').

⁶⁴ Although this is interest group legislation, it did not result from the efforts of a centrally-organized management lobbying effort. Romano's case study of the state legislative process here suggested that the statutes are initiated by threatened managers of local corporations and their assistants in the local corporate bar rather than by broad coalitions of business, labor, and community leaders. See Roberta Romano, *The Future of Hostile Takeovers: Legislation and Public Opinion*, 57 U. CIN. L. REV. 457, 461 n.11 (1988).

⁶⁵ The statutes evolved in succeeding generations. The first generation submitted tender offers to substantive review by state securities administrators; those statutes were held unconstitutional under the Commerce Clause in *Edgar v. MITE Corp.*, 457 U.S. 624, 640 (1982). The second generation limited the subject matter scope to regulation of internal corporate affairs. These statutes tend either to condition the voting right of bidders on the approval of the shareholders as a whole, impose freeze periods on combinations between bidders and targets, or require that an equal price be paid in the second stage of a two-tier acquisition. Some statutes combine these elements. These statutes survived constitutional challenge in *CTS Corp. v. Dynamics Corp. of Am.*, 481 U.S. 69, 94 (1987). Another variety confirms the legitimacy of board consideration of the constituents' interests other

ure⁶⁶ reinforced the opponents' assertion that management capture of the states leads to suboptimal lawmaking. Following the lead of Roberta Romano,⁶⁷ the market deterrent school moved to a middle ground position on charter competition.⁶⁸ From that perspective, they defend the state system, except to the extent that it inhibits the control market.

Others, principally Lucian Bebchuk, returned to the attack.⁶⁹ Bebchuk argued that the middle ground⁷⁰ result stems from a structural defect in the competitive system that disables the production of a maximizing legal regime. The market leads the competing states to focus on the variables that influence reincorporation decisions.⁷¹ There follows from this a concern for management preferences rather than shareholder value itself. Accordingly, nothing deters the states from pursuing policies of management accommodation with regard to the fiduciary and market deterrents.⁷² Bebchuk concluded that

than shareholders in takeover defense situations. For a summary, see Romano, *Genius of Corporate Law*, supra note 28, at 53-57.

⁶⁶ A large body of empirical work confirms that the antitakeover statutes had a harmful effect on shareholder value. This empirical result emerges from a complex picture that encompasses the negative price effects of contractual antitakeover provisions such as poison pills. For a summary of this work, see Romano, *Genius of Corporate Law*, supra note 28, at 60-75.

⁶⁷ See Romano, *Law as Product*, supra note 43, at 281.

⁶⁸ See, e.g., Frank H. Easterbrook & Daniel R. Fischel, *The Economic Structure of Corporate Law* 222 (1991) (concluding that the race to the top stands as refuted, but the proposition that competition creates a 'powerful tendency' to enact shareholder beneficial laws remains vital); Ralph K. Winter, The 'Race for the Top' Revisited: A Comment on Eisenberg, 89 COLUM. L. REV. 1526, 1528 (1989) (expressing more confidence in the view that Cary was wrong than in the view that state competition results in a race to the top).

⁶⁹ Bebchuk, supra note 36, at 1458-75; see also Charny, supra note 36, at 456 (promoting 'harmonization,' the promulgation of corporate rules by a central authority); Roberta S. Karmel, Is It Time for a Federal Corporation Law?, 57 BROOK. L. REV. 55, 91-96 (1991) (endorsing the promulgation of uniform federal corporate law); Joel Seligman, The Case for Minimum Corporate Law Standards, 49 MD. L. REV. 947, 971-74 (1990) (same); Joel Seligman, The New Corporate Law, 59 BROOK. L. REV. 1, 63 (1993) [hereinafter Seligman, *New Corporate Law*] (same).

⁷⁰ Bebchuk, supra note 36, at 1440A1. Bebchuk began his analysis of the problem by stating his assumption that, absent reasons to the contrary, state competition is more likely to produce an efficient rule than federal regulation. *Id.*

⁷¹ *Id.* at 1452-54.

⁷² Bebchuk identified a category of 'insignificantly redistributive,' management-favorable rules that always escape the market constraint. *Id.* at 1462. Bebchuk hypothesized a transaction undertaken by a \$1 billion firm that reduces shareholder value by \$1 million

because of this oversight, federal fiduciary standards should preempt most state takeover regulation.⁷³

The renewed debate on the desirability of federal intervention continues among those occupying different middle-ground views of charter competition. At the foundation of this debate lies the allocation of the theoretical burden of proof for or against intervention, the assumption being that the side bearing the burden loses the game. Several points are sharply controverted. Opponents of intervention point to a body of event studies showing that reincorporation in Delaware does not reduce shareholder value; proponents argue that convergence among the states on the basic points of corporate law denudes the results of persuasiveness.⁷⁴ Opponents draw on a contractual theory of the firm and

for the purpose of returning \$200,000 to management. *Id.* at 1463. The transaction is too small to excite a takeover, but as long as state law opens the door, management has every incentive to undertake it. *Id.* In addition, competition can cause the states to use their lawmaking power to impair the strength of market discipline even further, as the proliferation of antitakeover statutes demonstrates. *Id.* at 1467-68; see also Coffee, *supra* note 28, at 77-72 (discussing the impact of state antitakeover legislation); Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest Group Theory of Delaware Corporate Law*, 65 *TEX. L. REV.* 469, 471 (1987) (same).

⁷³ Bebchuk, *supra* note 36, at 1494-95.

⁷⁴ Roberta Romano conducted the leading event study showing that reincorporating firms experience an increase in value or no significant stock price declines. See Romano, *Law as Product*, *supra* note 43, at 279-80. Proponents of intervention respond with a number of standard questions about the shareholder vote on which reincorporation is conditioned. Even though Delaware has value-decreasing rules, the shareholders may approve a move for several reasons: because the move on the whole increases shareholder value, the shareholders have inadequate information, or management has tied the move to another corporate action they desire. Bebchuk, *supra* note 36, at 1471. These problems limit the normative force of the event studies: The stock prices may reflect the market's reaction to the developments signalled by the reincorporation rather than the reincorporation itself, and managers may systematically choose to reincorporate at moments when such information exists. *Id.* at 1449-50; see also Coffee, *supra* note 28, at 767-68 (offering a critique of Romano's analysis); Macey & Miller, *supra* note 71, at 482 (same); Romano, *Law as Product*, *supra* note 43, at 267 (discussing the implications of reincorporation). Romano, who recognizes the former possibility, responds that it is improbable that information tied to the move could swamp an otherwise negative stock price effect; rather, if management were manipulating the process, price-negative rather than price-neutral results should obtain for firms reincorporating for management-favorable purposes. Romano, *Genius of Corporate Law*, *supra* note 28, at 18. Bebchuk, following others, anticipates this point: Given convergence among the state codes, the absence of negative returns may only mean that the legal rules of the original and destination state are equally harmful. Bebchuk, *supra* note 36, at 1449; see also Coffee, *supra* note 28, at 767-68 (discussing the logical inferences to be derived from 'statistical noise'); Melvin A. Eisenberg, *The Structure of Corporation Law*,

point out that new federally mandated fiduciary deterrents would retard the evolution of contractual corporate arrangements⁷⁵; proponents respond that the consensus view on contracting out continues to favor fiduciary mandates in view of the rational apathy that impedes shareholder choices of governance terms.⁷⁶ Opponents argue that the federal political landscape remains as hostile as that of the states, making perverse effects a likely result of a federal law-reform movement;⁷⁷ proponents respond that the federal venue is marginally more hospitable and that centralized politics facilitate shareholder collective action.⁷⁸

4.6 Charter Competition as Regulatory Capture

This middle ground discussion of federal intervention takes on the binary quality of the old race to the top/race to the bottom discussion as its participants iterate positions from the historic debate over market and fiduciary deterrent strategies. However, as the replay continues, each side has recognized possibilities for both market success and market failure. This more open-ended theoretical framework allows more flexibility in the diagnosis of the problem, and the stronger assertions of regulatory competition theory have dropped out of the picture for the most part. The 1980s anti-takeover alliance between the states and the managers has dispelled the notion that identification of a market phenomenon at a significant stage in the lawmaking process, taken

89 COLUM. L. REV. 1461, 1508 (1989); Macey & Miller, *supra* note 71, at 482-83 (discussing the market signals produced by relocation to Delaware). Furthermore, the fact that reincorporation does not decrease value overall does not prove that competition produces desirable results on all corporate issues. Bebchuk, *supra* note 36, at 1450.

Bebchuk, in sum, argues that the event studies must be seen in temporal perspective. *Id.* at 1448-51. They do contradict Cary's picture of an ever-lowering race to the bottom with Delaware in the lead. However, once we accept that point and join Romano on the middle ground, the probative force of the studies diminishes. The race, in effect, bottomed out before the studies were undertaken. *Id.* The prospective question is whether intervention can cause the numbers to improve. *Id.* at 1509-10.

In Romano's view, acknowledging disproof of the race to the bottom decides the debate over intervention. Given agreement on the beneficial effects of competition, she said, the burden is on advocates of intervention to demonstrate 'empirically which particular code provisions harm shareholders and why national legislation would be more likely to alleviate the problem.' Romano, *Genius of Corporate Law*, *supra* note 28, at 19.

⁷⁵ Romano, *Genius of Corporate Law*, *supra* note 28, at 90-91.

⁷⁶ Bebchuk, *supra* note 36, at 1496-99.

⁷⁷ Romano, *Genius of Corporate Law*, *supra* note 28, at 50, 75-84.

⁷⁸ William W. Bratton, Corporate Law's Race to Nowhere in Particular, 44 U. TORONTO L.J. 401, 432 (1994).

alone, assures the ideal result of legislation based solely on the exogenous preferences of individuals. It has become clear that imbalanced interest group influence in this market-driven lawmaking process prevents that result, divesting regulatory competition theory of a legitimating effect.

Regulatory competition matches individual preferences and legal results because actors have the opportunity to exit cheaply from an unsatisfactory jurisdiction. The charter system, of course, does allow for exit from an unsatisfactory jurisdiction, but, because the exit privilege applies to firms rather than to shareholders, it does nothing to ameliorate the agency problem. Corporate law has evolved under charter competition to block shareholder access to the determination of reincorporation decisions.⁷⁹ Existing market disciplines offer no way around that barrier because they create no incentives to encourage the development of a shareholder-favorable jurisdiction.⁸⁰ Successful control contests, whether by takeover or proxy fight, displace one group of managers with another. The new management, unless it has taken the firm private, remains in an agency relationship with the firm's shareholders and thus has no reason to look for a jurisdiction favorable to the shareholder interest.⁸¹ In addition, due to the peculiarities of America's constitutional structure, the competing jurisdictions—which lack a balancing incentive—have national lawmaking power over the shareholders of domiciliary corporations. In this variant of regulatory competition, then, exit from one jurisdiction provides no remedy for the dissatisfactions of the disadvantaged interest group.

4.6.1 Capture Theories of Regulation

The mixed framework invites a retelling of the charter competition story in

⁷⁹ See *infra* notes 275-83 and accompanying text.

⁸⁰ Cf. Richard L. Revesz, *Rehabilitating Interstate Competition: Rethinking the 'Race-to-the-Boat' Rationale for Federal Environmental Regulation*, 67 N.Y.U. L. REV. 1210, 1249 (1992) (arguing that the charter competition process is not defective in itself, but that the unresolved principal-agent problem respecting the selection of the state of incorporation makes locational decisions defective).

⁸¹ The displacing group that plans to make further acquisitions with the target has an interest in the removal of state law antitakeover barriers. However, reincorporation to a hypothetical shareholder-favorable jurisdiction would not help with this problem, since the law of the target jurisdiction applies in a takeover. The only solution to the acquiring firm's problem, then, is interest group pressure to work against antitakeover legislation nationwide. Yet, at this point, conflicting interests among acquiring firms enter into the picture. Today's acquirer may be tomorrow's target; the managers of large acquirers can afford to be patient and work around state barriers in making hostile acquisitions, meanwhile enjoying the prerogatives of the state law regime.

terms of both the economic and governmental politics of interest groups and organizations. In this story, charter competition becomes the mainspring of a uniquely stable arrangement of regulatory capture.

Under capture theories of regulation, interest groups and political decision-makers enter into jointly maximizing relationships. The simple demand model of capture asserts that lawmaking follows the lawmakers' responses to demand patterns.⁸² Particular responses depend on interactions between the lawmakers' risk profiles and the projected benefits of legislative action.⁸³ The lawmaker, being risk averse, tries to avoid conflicts-given no demand for legislation, nothing is done; given organized demand, the lawmaker attempts to satisfy the interest group making the demand with beneficial legislation.⁸⁴ In addition, interest groups desiring to influence legislation encounter collective action problems.⁸⁵ Different groups have different abilities to overcome them-the smaller the group and the higher the per capita stake of its members, the greater the likelihood that the members will work out a collective arrangement and enjoy the benefits of governmental influence.⁸⁶ This activity results, according to the theorists of the Virginia School, in a social loss from rent-

⁸² See Robert D. Tollison, *Public Choice and Legislation*, 74 VA. L. REV. 339, 343-44 (1988); see also Richard A. Posner, *Economics, Politics, and the Reading of Statutes and the Constitution*, 49 U. CHI. L. REV. 263, 265-68 (1982) (discussing the interest-group theory).

⁸³ Sam Peltzman, *Toward a More General Theory of Regulation*, 19 J.L. & ECON. 211, 214 (1976). Benefits can come in the form of resources or favorable consequences for reelection. George J. Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. & MGMT. SCI. 3, 10-13 (1971). With corporate law, the benefit tends to be rents from corporate business.

⁸⁴ See Gary S. Becker, *A Theory of Competition Among Pressure Groups for Political Influence*, 1983 Q.J. ECON. 371, 39-96 (discussing the impact on the political redistribution of income resulting from competition among political pressure groups vying for political favors).

⁸⁵ Olson's fundamental insight is that in a large, heterogeneous community, individuals will prefer not to pay the full cost of the provision of nonexcludable public goods and that, as a result, they will be undersupplied. A free-rider problem must be overcome if public goods are to be supplied, and voluntary compliance can be secured only by introducing selective incentives (such as fees) or sanctions. OLSON, *supra* note 48, at 50-51, 133-34. The result is that rational individuals are motivated to join interest groups based on individualized selective incentives. *Id.* at 60-65. Given the free-rider problem, large groups will have difficulty achieving their goals. *Id.* at 35-36.

⁸⁶ It seems to follow that, in a case in which more than one interest group manages to compete to achieve influence, the risk-averse legislator will delegate ultimate regulatory authority to an agency. Once that occurs, the agency becomes the venue of interest group activities. See James Wilson, *The Politics of Regulation* 388-89 (1980).

seeking.⁸⁷ Legislators create rents for the benefit of successful interest groups, distributing them based on a self-seeking vote calculus.⁸⁸

An additional body of capture theory supplements this demand model with a supply-side story. Exclusively demand-based models of law production tend to treat the political process as a black box and, as a result, do not attempt to describe how legislative trades are accomplished and enforced.⁸⁹ This is a problem, since legislative trades, unlike well-drafted private contracts, can be undone at the subsequent behest of a competing group. For example, an interest group deal, obtained in the legislature through logrolling and other trading mechanisms and then embodied in a legislative directive, can be undercut later by an administrative agency responding to a competing interest group. In the alternative, representatives can amend or repeal a piece of legislation later at the request of a competing group. Supply-side explanations of interest-group dealmaking confront this problem of political insecurity by drawing on organizational economics to show that institutional arrangements

⁸⁷ The Virginia School concentrates on the economic theory of legislation. The idea is simple: Government creates rent that is captured by interest groups. Politicians pass legislation that benefits the interest groups that are better organized, and rents are distributed based on the welfare maximization of the political decisionmakers. The cost of supplying rents to well-organized groups is passed on to poorly organized groups.

The upshot is a waste of consumer surplus. Governments create rents and can appropriate them, and they are likely to squander the rents they capture; as a result, everyone is worse off. Under this view, the political process is justified only if lawmakers produce legislation obtained without influence. The task of politics, then, is to create legislation based on the exogenous preferences of individuals. See Richard S. Higgins et al., *Free Entry and Efficient Rent-Seeking*, in *The Political Economy of Rent-Seeking* 127, 128 (Charles K. Rowley et al. eds., 1988); Gordon Tullock, *The Welfare Costs of Tariffs, Monopolies, and Theft*, in *Toward a Rent-Seeking Society* 39, 46-47 (James Buchanan et al. eds., 1980).

⁸⁸ Policies are evaluated in terms of the distribution of costs and benefits based on the assumption of a level of votes for each dollar expended. See William C. Mitchell, *Interest Groups: Economic Perspectives and Contributions*, 2 J. THEORETICAL POL. 85, 98-99 (1990); Tollison, *supra* note 81, at 339-50; Barry R. Weingast, *The Congressional Bureaucratic System: A Principal-Agent Perspective (With Applications to the SEC)*, 44 PUB. CHOICE 147, 147-48 (1984).

⁸⁹ Barry R. Weingast & William J. Marshall, *The Industrial Organization of Congress; or, Why Legislatures, Like Firms, Are Not Organized as Markets*, 96 J. POL. ECON. 132, 133 (1988); see also Tollison, *supra* note 81, at 347-66 (summarizing supply-side research). Such models also leave unexplained such phenomena as simultaneous provision of policy benefits to multiple diverse interests. See Daniel A. Farber, *Politics and Procedure in Environmental Law*, 8 J.L. ECON. & ORGS. 59, 65 (1992) (concluding that the special interest model fails to explain environmental legislation).

have an impact on outcomes. This body of work disaggregates the government into a complex of principal-agent relationships.⁹⁰ In these stories, legislatures develop process and structure machinery to control the opportunistic conduct of both career bureaucrats and legislators.⁹¹ These devices include the legislative committee system, which helps to overcome problems of asymmetric information between legislative principals and bureaucratic agents through ex post monitoring, and process requirements for rulemaking, which provide advance notice of noncomplying conduct.⁹² The processes of the legislature also contribute to transactional stability: Legislative procedures and committee jurisdictions give the congressional gatekeeper the ability to resist short-term internal pressures.⁹³

⁹⁰ Matthew D. McCubbins et al., *Administrative Procedures as Instruments of Political Control*, 3 J.L. ECON. & ORGS. 243, 243-44 (1987); Weingast, *supra* note 87, at 148.

⁹¹ Matthew D. McCubbins et al., *Structure and Process, Politics and Policy: Administrative Arrangements and the Political Control of Agencies*, 75 VA. L. REV. 431, 441 (1989). A related, and more abstract, line of discourse considers the effects of given modes of voting process on the ordering of preferences among elected representatives, refuting the chaos scholars predicted under early social choice theory. See, e.g., Peter C. Ordeshook, *Game Theory and Political Theory: an Introduction* 2-301 (1986) (discussing agenda control and outcome); David P. Baron & John A. Ferejohn, *Bargaining in Legislatures*, 83 AM. POL. SCI. REV. 1181, 1189-98 (1989) (considering closed and open rules of legislative amendment); Jules Coleman & John Ferejohn, *Democracy and Social Choice*, 97 ETHICS 6, 8-9 (1986) (finding that the particular content and contour of institutions determines the extent to which electoral outcomes reflect popular preferences).

⁹² For a formal agency model of information asymmetries and capture relationships between legislatures and agencies, and between producer groups and public interest groups, see Jean-Jacques Laffont & Jean Tirole, *A Theory of Incentives in Procurement and Regulation* 480-500 (1993). But cf. Andrei Shleifer & Robert W. Vishny, *Politicians and Firms* (1994) (Harvard Institute of Economic Research Discussion Paper No. 1686) (unpublished manuscript on file with the authors) (claiming that approach turning on a complete information model is not plausible in cases where the problem of inefficiency is essential to the politicians' performance, such as in state-run enterprises; therefore, corruption is central to the operation of the firm).

For an application of this approach keyed to legal policymaking, see Jonathan R. Macey, *Organizational Design and the Political Control of Administrative Agencies*, 8 J.L. ECON. & ORGS. 93, 99-103 (1992). Macey contends that legislators are able to capture higher rents only if they can surmount the agency problem. *Id.* at 100. In Macey's view, & post monitoring and punishments may not be sufficient to solve the agency problem. Ex ante structuring or 'hard-wiring' of the agency works better, and the interest groups that pay for the legislation can be expected to attempt to secure it. *Id.* at 1(X-03).

⁹³ Kenneth A. Shepsle, *Congress is a 'They,' Not an 'It': Legislative Intent as Oxymoron*, 12 INT'L REV. L. & ECON. 239, 245 (1992). Moe, *supra* note 42, at 122-23, criticizes this literature for its adherence to a model of motivation grounded in strategic rationality,

4.6.2 Charter Competition as a Form of Capture

These capture theories of legislation and administration provide a useful basis for explaining the success of the charter competition system and the preeminence of Delaware. Exit through reincorporation provides a potent ex post enforcement device to the managers who purchase legislation from the target state, particularly a small state dependent on charter revenues. Ex ante, the code the managers purchase provides them with control of the enforcing exit decision by blocking shareholder access to the charter.⁹⁴ The state's incentive to collect rents from new incorporations assures that the process legislation securing the exit route will not be amended in the future to make exit more difficult. Thus the state's rent incentive joins the deterrent of possible reincorporation to assure the managers that the deal will stick. The combination does more than that, however. It also mitigates any collective action problems the managers might encounter in getting the future legislation. Should desired legislation not be obtained, exit can be effected unilaterally, and there will remain up to forty-nine states from which to choose. Furthermore, the chartering state's rent flow includes fees to practicing lawyers in addition to franchise taxes. This assures an identity of interests between management and key actors on the supply side. In this scheme, the organized bar in the chartering state can be expected to act as an effective advocate for the management interest, without forcing management to organize a trade association to enter into a formal lobbying relationship. Delaware practice confirms this prediction.⁹⁵ Delaware delegates to its bar association both agenda control and drafting responsibility for any amendments to its corporate code. The bar and legislature have a long-standing 'understanding'-amendments to the corporations code must first be drafted and approved by the bar association's corporate law section and the bar association itself.⁹⁶

asserting that a thick description of the motivations of different types of actors provides knowledge about authority that the principal-agent models do not offer.

⁹⁴ See *infra* notes 259-74 and accompanying text.

⁹⁵ It should be noted that the interests of the bar and management diverge on the matter of litigation incentives. For discussion, see *infra* text accompanying notes 126-37.

⁹⁶ See Andrew G.T. Moore II, *State Competition: Panel Response*, 8 *CARDOZO L. REV.* 779, 780-81 (1987). Active drafting and discussion is limited largely to the corporate law section. See Curtis Alva, *Delaware and the Market for Corporate Charters: History and Agency*, 15 *DEL. J. CORP. L.* 885, 888-92 (1990). The section itself performs the legislative function of sifting the comments of interested parties. Each of the three largest corporate servicing firms have representatives to the section. *Id.* at 888-92, 910.

The legislature rubber stamps the bar's recommendations; the executive branch's role is limited to representation at bar association meetings on invitation. *Id.* at 888-92; see also

Capture by charter competition exacerbates the shareholders' collective action problem even as it reduces that of management. State law not only blocks shareholder access to the charter, it provides only management with routine compensation for expenses incurred in voting contests.⁹⁷ Meanwhile, the bar emerges as the only interest group within the chartering state with an incentive to advance the shareholders' interest in lawmaking processes. Litigating lawyers promote shareholder welfare as an incident to making a living as enforcers of the fiduciary deterrent. Unfortunately, this confluence of interests results in a strictly limited set of shareholder benefits. The lawyers have an incentive to promote lawmaking that strengthens the market deterrent only if the change would lead to additional litigable disputes. The same applies to lawmaking that enhances the possibilities for shareholder-enforced self-regulation. Such incentives seem unlikely to arise in practice. Fiduciary breaches that bring rents to lawyers stem from excess management influence; any market or self-regulatory governance strategy that has a cognizable chance of working well in practice ultimately threatens to diminish those rents by reducing the numbers of unproductive influence activities. In addition, the bar's interest diverges from the shareholders' even within the sphere of fiduciary enforcement, with the bar favoring a system that trades substantial money judgments to shareholders for substantial attorneys' fees.⁹⁸

In short, no interest group in the chartering state has a rent incentive linked to the shareholders' interest in minimizing influence costs within the firm. The shareholders, then, must self-organize⁹⁹ to advance an agenda in state lawmaking processes. Unfortunately, the charter competition system structurally limits prospects for payoffs that would justify the costs of organization. Furthermore, any sustained shareholder effort would have to be pursued in multiple jurisdictions. By default, then, federal law emerges as the preferred venue for organized shareholder efforts to alter legal structures to make firms operate more effectively.¹⁰⁰ Federal lawmakers, unlike their counterparts in

David S. Schaffer, Jr., *Delaware's Limit on Director Liability: How the Market for Incorporation Shapes Corporate Law*, 10 HARV. J.L. & PUB. POL'Y 665, 682-84 (1987) (discussing the 1%7 revision of Delaware corporate law).

⁹⁷ It compensates only shareholder winners in board control contests and provides no compensation at all to shareholders who oppose management positions in issue contests. See *Rosenfeld v. Fairchild Engine & Airplane Corp.*, 128 N.E.2d 291 (N.Y. 1955). For discussion, see Lucian Arye Bebchuk & Marcel Kahan, *A Framework for Analyzing Legal Policy Towards Proxy Contests*, 78 CAL. L. REV. 1071 passim (1990).

⁹⁸ For discussion of the role that the lawyers' interest plays in shaping Delaware law, see *infra* text accompanying notes 131-37.

⁹⁹ Shareholders also may rely on independent allies such as academics.

¹⁰⁰ This conclusion obtains even though Delaware's compact and relatively informal

the states, have not been captured by the management side pursuant to a deal with sticking power. This is, of course, only a negative qualification that by no means implies probable success for a shareholder influence campaign. Process costs still loom large at the federal level, and management retains both organizational advantages and well-worn paths of influence. But the turf at least is open. There are no rent incentives tied to chartering decisions, and a large number of players, each making complex and political calculations in a dynamic environment, makes it easier to contest management influence.¹⁰¹

4.7 Conflicting Demands on the Captured State

We draw no race to the bottom conclusions from this capture model of corporate lawmaking. Rather, the model serves to explicate the theoretical implications of the middle ground framework, putting a different gloss on the same practices purveyed as productive relational contracting in the race to the top story. Since many areas of state corporate law find shareholder and management interests in alignment, it complicates, but does not displace, the relational contract reading.

The capture model does suggest exploration of strategies of federal intervention designed to diminish state law's imbalanced supply-side incentives and imbalanced opportunities to make demands. However, it does not thereby imply that federal fiduciary standards are the most desirable mode of intervention. Federal fiduciary standards would ameliorate both the supply and demand-side problems by imposing shareholder-favorable norms. They also would entail a difficult trade off, because process infirmities could follow from the appointment of the federal judicial system to the shareholder guardian role. The infirmities lie in the possibility that a preemptive change in the venue of corporate common lawmaking from the Delaware courts to the federal courts would so materially alter the composition of the product sold in the charter market as to denude Delaware of significant relational capital. The loss of the first-mover role in common lawmaking would leave Delaware marketing a

lawmaking processes, see *supra* note 95 and accompanying text, hold out significant process cost advantages. For a discussion of the relative advantages and disadvantages of the federal venue, compare Romano, *Genius of Corporate Law*, *supra* note 28, at 7581, with Bratton, *supra* note 77, at 430-33.

¹⁰¹ The SEC embodies this possibility: Historically, its actors tend to satisfy the demands of neither the shareholder nor the management side. In addition, they bring an inherited, albeit limited ideology of shareholder protection to their ongoing mediative activities. Recent amendments to the proxy rules promulgated at the instance of institutional shareholder activists, see *infra* note 180, concretely demonstrate this agency's continuing receptiveness to shareholder agenda items.

product of diminished value and weaken its relational tie with firms. The rents that support Delaware as a center of information on corporate governance disputes could dissipate, possibly leading to corporate lawmaking on a level of diminished sophistication.

Thus, one assertion of regulatory competition theory—that national lawmaking procedures carry process infirmities that are avoided when the subject matter is left to the competing states—continues to bear on the debate. The captured state system can enhance economic welfare to the extent that its competitive element causes the lawmaker to weigh the regulations' benefit and harm to the firm as a whole.¹⁰² Arguably, then, the preferred solution to the corporate agency problem leaves the subject matter with the states but finds a means to interpose the shareholder interest into state lawmakers' demand picture.¹⁰³ This would render the capture benign.¹⁰⁴

Past practice provides a base point from which to begin this reordering of incentives. Shareholder demands have, in fact, figured into the existing competitive regime in a secondary posture, influencing the shape of Delaware's fiduciary case law. This result appears surprising if we view state law under the pure product competition model. To account for it, the model must be expanded to encompass the political instability that results from the national attention that Delaware lawmaking attracts because of its dominant market position.

4.7.1 Delaware Lawmaking and the Threat of Federal Intervention

The deal struck between the chartering state and management can never be entirely secure because the possibility of removal of corporate lawmaking to the federal level inheres in the constitutional structure of the United States. Delaware, as the entity most dependent on corporate law revenues, is the contracting state most prone to view that possibility as a threat. This structural constant suggests that Delaware lawmakers may have secondary incentives to

¹⁰² See Ayres & Braithwaite, *supra* note 13, at 63- (providing a prisoners' dilemma model of agency capture).

¹⁰³ This point can be expanded by analogy to the literature on legislative control of agencies, under which the question of political control has been addressed in terms of the economic principal-agent problem. See generally, e.g., McCobbins et al., *supra* note 89. A federally imposed fiduciary regime would restrict opportunities for this beneficial engagement because it would remove the lawmaker from an immediate agency relationship with the firm.

¹⁰⁴ Restating this point, the charter competition problem stems from the same incentive problems and barriers to collective action that create the corporate agency problem in the first place.

respond to shareholder interests.¹⁰⁵

It can be plausibly hypothesized that Delaware actors remain averse to possible destructive exercises of federal preemptive power and have incentives to avoid exciting its application.¹⁰⁶ Federal law reform discussions of the past

¹⁰⁵ A number of commentators have recognized this possibility. See Bebchuk, *supra* note 36, at 1455; Cary, *supra* note 10, at 688; Eisenberg, *supra* note 73, at 1512.

¹⁰⁶ This dual demand model's plausibility depends on three assumptions. First, actors in Delaware must perceive that their activities have the potential to excite political action at the national level. Second, Delaware actors must perceive that the shareholder interest finds a voice among the actors and groups that influence federal law. Third, the projected federal political action must have a negative impact either on the charter competition system as a whole or on the relative place of Delaware in the system to reduce Delaware's rent flow.

As to the first assumption, periodic calls for federal intervention have, over the years, given Delaware reasons for concern. Although federal intervention has not been a present prospect since the late 1970s, see *infra* note 114, the subject has remained a staple of corporate law discourse. Anecdotal evidence shows that Delaware lawmakers keep it in mind when they take politically sensitive steps. The Delaware bar's concern about federal responses is confirmed in accounts of its deliberations on new legislation. When the bar first considered (and rejected) an antitakeover statute, it received comment letters from Martin Lipton and Joseph Flom warning that enactment might excite federal intervention. Such worries were expressed at the committee meeting on the proposal. See Alva, *supra* note 95, at 906-08.

The second assumption has been the subject of debate. Professor Romano argues that management replicates its dominant influence in the states at the federal level. She inspected the federal corporate law reform politics of the 1980s to show that management voices were heard the most often. Romano surveyed the content of both federal takeover legislation proposed during the period 1969-87 and of interest group representation in the accompanying legislative processes. She found that the overwhelming majority of bills had an anti-bidder aspect and that management voices appeared much more frequently than shareholder or labor voices. ROMANO, *GENIUS OF CORPORATE LAW*, *supra* note 28, at 7-81. Romano also showed, however, that bureaucratic, political, and academic voices were heard in quantity during the 1980s. *Id.* at 77. In any event, to the extent that large stakes in the status quo make Delaware's lawmakers risk averse, any active federal politics with possible adverse consequences might prompt them to make a preemptive response.

Regarding the third assumption, the gravity of a federal threat will vary with the particular form of federal intervention proposed. A discrete provision might impair Delaware's position only incidentally, blocking a particular management accommodation, but applying the block to all 50 states. As examples, consider (1) the all holders rule, Rule 14d-10 under section 14(d) of the Securities Exchange Act of 1934, 17 C.F.R. 240.14d-10 (1994), providing that any tender offer must be open to all holders of the subject class of securities, preempting the defensive tactic sustained in *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985); and (2) the special tax on greenmail profits, I.R.C. § 5881 (1991), enacted in 1987, which imposes a 50% excise tax on profit realized in a greenmail

two decades have given Delaware actors cause for concern because the often-proposed remedy of federal fiduciary standards would have an adverse impact on their interests. This vulnerability stems from the competitive evolution of corporate statutory law. Competition has caused state corporate codes to converge in their broad outlines. As a result, Delaware's case law, judges, and speedy process figure prominently in its line of legal products.¹⁰⁷ Federal intervention might deprive Delaware of the principal justification for its premium price, resulting in an outbreak of price competition in the market and the erosion of Delaware's position as an informational center. Recognition of a perceived federal threat implies a model in which Delaware faces conflicting demands, each threatening potential negative consequences. First, the management interest must be satisfied to prevent corporate migration out of the state and entry into competition by competing states. Second, federal actors, as proxies for the shareholders, must be satisfied to avoid destructive intervention. The conflicting demands complicate the business of response: Professor Eisenberg has suggested that the conflict leaves Delaware with an incentive to avoid taking the lead in adopting rules favoring managers at the shareholders' expense. Other states have a different incentive. If they offer innovative management-side payments, they may siphon business from Delaware; if the federal government intervenes to stop them, they lose little. So long as a given state has a small market share, its actions attract little attention. Delaware, in contrast, cannot take any significant steps without close scrutiny nationwide.¹⁰⁸ It remains under pressure to follow new developments else-

transaction. In either case, Delaware no longer can take a competitive lead on the subject matter regulated, but neither can any other state. The overall field of subject matter for competition shrinks slightly, but not enough cognizably to impair Delaware's position. Furthermore, a federal provision might even result in a short-term enhancement of Delaware's position. Consider, as an example, the proposals for national antitakeover legislation made during the mid-1980s. At that time, worries about federal responses contributed to Delaware's hesitancy to initiate takeover defense legislation. Federal intervention on either side would have settled the matter, removing a threat of competition from other states.

¹⁰⁷ In addition to a large collection of past decisions, Delaware sells a unique, technically qualified judiciary and speedy determination of new disputes. Bayless Manning identified Delaware's judiciary as its prime attraction, comparing Delaware to the medieval law merchant. Bayless Manning, *State Competition: Panel Response*, 8 *CARDOZO L. REV.* 779, 7-85 (1987).

For confirmation of this point from a game theory perspective, see Ian Ayres, *Making a Difference: The Contractual Contributions of Easterbrook and Fischel*, 59 *U. CHI. L. REV.* 1391, 141-15 (1992) (reviewing Frank H. Easterbrook & Daniel R. Fischel, *The Economic Structure of Corporate Law* (1991)).

¹⁰⁸ Eisenberg, *supra* note 73, at 1512-13; see also Bebchuk, *supra* note 36, at 1455

where, but emerges in a mediative role.

A question arises as to how Delaware, alone in this competing demand situation, can structure a mediative response without losing business, given a market still keyed to management preferences.¹⁰⁹ Two factors make this picture plausible. First, no full-service alternative domicile exists, and only a handful of other jurisdictions have strong incentives to incur the start-up costs to market a full-service operation. But a potential competitor has no assurance that a third jurisdiction will not duplicate its efforts,¹¹⁰ and given the low cost of reincorporation,¹¹¹ no assurance that its new customers will remain. Second, the shareholders' newly discovered capability of self-protective collective action may effectively deter management reincorporation proposals. Beginning in the late 1980s, incidents of shareholder resistance caused managers to drop the assumption of automatic shareholder approval of anti-takeover proposals requiring charter amendment.¹¹² Thus, departure from Delaware may not be the open option it used to be.

Evidence of the dual demand model's robustness can be found in the recent pattern of Delaware lawmaking. Given statutory convergence among the states and the dominance of the management interest, the problems of conflicting demand rarely show up in corporate legislative process. Anti-takeover legislation is the principal recent instance, and Delaware's corporate bar moved late

(pointing out that there remains a range within which states can maneuver without fear of federal intervention).

¹⁰⁹ Delaware's mediative output can be explained in terms of the interests of managers as a group. Well-timed interventions to protect shareholders serve to defuse the federal threat and to make Delaware a buffer state that protects corporations from federal intervention. However, the benefits of a mediative jurisprudence are more questionable from the point of view of individual managers seeking an optimal environment. They have an apparent incentive to cause their firms to migrate to states adopting less equivocal anti-takeover policies, free riding on the firms that stay. Of course, if a large number of firms surmounted this collective action barrier and successfully shopped for a more responsive jurisdiction, federal intervention would become more likely. The same might occur if a large number of firms left Delaware, starting a new race to the bottom.

¹¹⁰ See Daniels, *supra* note 52, at 182.

¹¹¹ See Black, *supra* note 28, at 551, 574, 586-90.

¹¹² See *infra* notes 162-80 and accompanying text. Romano contributed some evidence of this phenomenon with a report on the behavior of public corporations subject to the 1990 Pennsylvania takeover statute. The Pennsylvania statute, like most takeover statutes, included a default rule that applied the statute to all corporations that failed to take affirmative action to opt out. See PA. CONS. STAT. §§ 2571-75 (1994). Despite this, pressure from institutional investors resulted in opting out by the boards of 127 firms; only 72 firms stayed in. Romano, *Genius of Corporate Law*, *supra* note 28, at 68-69. Presumably, opportunistic reincorporation proposals would excite similar shareholder attention.

and with caution in putting an anti-takeover statute before its legislature.¹¹³ The conflict becomes more apparent in the adjudication of fiduciary cases, particularly those dealing with corporate control transfers¹¹⁴ Here the shareholder interest has found Delaware intermittently responsive. The Delaware judiciary abruptly changed a long-standing habit of monolithic fidelity to management interests in 1977,¹¹⁵ and Cary's 1975 article has been accorded a role in the break.¹¹⁶ The federal threat, thus crystallized, impressed upon the Delaware courts the practical importance of solicitude to shareholder interests.¹¹⁷ This post-Cary behavior pattern has persisted and still yields headlines as highly publicized cases articulate surprising new shareholder-protective applications of basic fiduciary rules.¹¹⁸ The pattern has been vol-

¹¹³ See Alva, *supra* note 95, at 906-08.

¹¹⁴ This is analogous to the allocation of responsibility between legislatures and agencies. Legislators faced with a conflicting demand problem can avoid confrontation with the competing interest groups and resort to the expedient of delegating lawmaking authority to an agency; with state corporate law, the judiciary tends to assume this function. Delaware, as it responded to sensitive developments in the corporate control market of the 1980s, kept open its options by employing equivocal judicial rules in preference to clear cut legislation.

¹¹⁵ See *Singer v. Magnavox Co.*, 380 A.2d 969, 976-80 (Del. 1977) (imposing strict fiduciary standards on parent firms in cash-out mergers). The Singer rule was in turn rejected for a looser, process-based approach in *Weinberger v. UOP, Inc.*, 457 A.2d 701, 704, 715 (Del. 1983). Oddly, Singer was decided after the immediate threat of federal preemption of state fiduciary rules under the antifraud rules of the securities laws had been removed by the Supreme Court in *Santa Fe Indus. v. Green*, 430 U.S. 462, 479-80 (1977). The story told at the time was that the brush with preemption at the hands of the federal judiciary and the wider critical atmosphere provoked by Cary and others had prompted the Delaware Supreme Court to reverse its direction and become more accommodating to the interests of investors to diminish the threat of intervention.

¹¹⁶ The federal threat, and Cary's association with it, appears in accounts of these events. See, e.g., Coffee, *supra* note 28, at 764-66; Eisenberg, *supra* note 73, at 1511-13.

¹¹⁷ Prior to *Santa Fe Indus. v. Green*, 430 U.S. 462 (1977), there was a cognizable chance that much conduct covered by state fiduciary law would be found to be 'manipulative' or 'fraudulent' conduct violative of section 10(b) of the Securities Exchange Act of 1934 and rule 10b-5 thereunder. The antimanageial political climate of the time also resulted in the introduction of preemptive legislation in Congress. See S. 2567, 96th Cong., 2d Sess. (1980).

¹¹⁸ See *Paramount Comms., Inc. v. QVC Network, Inc.*, 637 A.2d 34, 46-48 (Del. 1993) (holding that management has an obligation to achieve the best value reasonably available for shareholders); *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 366-71 (Del. 1993) (applying a heightened duty of care scrutiny of boardroom merger decision and suggesting an expanded remedial concept inclusive of post-merger gain); *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 182 (Del. 1986) (inventing a duty of management that changed from defending against a tender offer to auctioning the company in limited

atile,¹¹⁹ however, and shareholder protective intervention has not been a constant theme. The Delaware courts' indulgence in this back-and-forth at apparent cost to a reputation for certainty, predictability, and management responsiveness confirms the presence of competing demands.

Two caveats must be noted. First, the federal threat does not play an exclusive causative role in this conflicting demand model. Courts and judges sell reputations for speed, dependability, and predictability, but they also stake reputational capital in their working roles. This gives the judges an independent incentive to protect the legitimacy of the system¹²⁰ by balancing the satisfaction of interest group demands with public-regarding results. Delaware judges, responding to Cary's well-publicized allegations of corruption,¹²¹ have declared a commitment to this role integrity.¹²² They describe themselves

circumstances); *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 95-55 (Del. 1985) (applying an expanded review of tender offer defensive tactics under a proportionality test); *Smith v. Van Gorkom*, 488 A.2d 858, 873-81 (Del. 1985) (suddenly expanding the duty of care to cover board approval of arm's length merger).

¹¹⁹ Equally famous cases often appear to restrict the application of the new rules. See *Paramount Comms., Inc. v. Time Inc.*, 571 A.2d 1140, 1150-54 (Del. 1989) (limiting application of *Unocal* and *Revlon*); *Moran v. Household Int'l, Inc.*, 500 A.2d 1346, 1356-57 (Del. 1985) (sustaining 'poison pill defense' under *Unocal*); *Weinberger v. UOP, Inc.*, 457 A.2d 701, 703-04 (Del. 1983) (overruling *Singer* in favor of a less restrictive process scrutiny of cash-out mergers).

The legislature, prompted by the corporate committee of the Delaware state bar, entered in on management's side in one famous instance. After *Smith v. Van Gorkom*'s application of the duty of care caused nervousness in boardrooms and a substantial increase in insurance premiums, the legislature amended the code to permit firms to opt out of the duty of care by charter amendment. See DEL. CODE ANN., tit. 8, § 102(b)(7) (1991) (permitting opting out of personal liability of directors for duty of care violations).

¹²⁰ See Eric Rasmusen, *Judicial Legitimacy as a Repeated Game*, 10 J.L. ECON. & ORGS. 63, 72-74, 7880 (1994) (offering a repeat-game model of judicial motivation with infinite time horizons). As occurs with repeat games, the model results in a multiplicity of equilibria in which the outcome depends on the players' expectations. *Id.* at 74. In Rasmusen's model, judges follow precedent if there is a self-enforcing system based less on compulsion than on the need to uphold systemic legitimacy. *Id.* at 72-74. In the case of Delaware, of course, systemic legitimacy has pointed in the opposite direction. See also Thomas J. Miceli & Metin M. Cosgel, *Reputation and Judicial Decision-making*, 23 J. ECON. BEHAV. & ORG. 31, 42A9 (1994) (modelling the preferences of judges on a utility function that includes both a private and a reputational component, with the decision as to whether to follow precedent turning on a trade-off between the two components, and the equilibrium rate of adherence to precedent depending on the distribution of preferences across the population).

¹²¹ Cary, *supra* note 10, at 684, 6-98.

¹²² See Coffee, *supra* note 28, at 764-5.

as mediators between management and shareholders-protectors of market risk-taking who nevertheless impose ethical constraints.¹²³

Second, the identification of competing demand should not be taken to predict a pattern of even-handed mediation. Although the federal threat holds out the potential of substantial injury, it remains an unlikely event. Potential impairment of competitive position and loss of incorporations is a more immediate problem for Delaware, and also amounts to a competing reputational concern for Delaware judges, given limitations on their tenure.¹²⁴ If we look at the pattern the Delaware courts took during the 1980s in charting a course between competing demands on sensitive corporate control matters, we can infer that the Delaware courts took advantage of an informational slack¹²⁵ to develop a body of case law that gave an appearance of greater weight to shareholder interests than was justified by the actual payoffs. In highly publicized cases, the Delaware courts announced vague standards that held out the prospect of enhancing shareholder value. But in the less well-publicized cases that followed, they took the opportunity held out by complex facts to refrain from applying the standards in management-constraining ways.¹²⁶ The full set of results tallied by the lawyers who make reincorporation decisions signalled considerably more room for management maneuver than did the public profile signalled by the leading cases.

4.7.2 The Litigation Anomaly

Full description of the complex of incentives that shape Delaware law requires further consideration of conflicting interests on the supply side. We have

¹²³ See Moore, *supra* note 95, at 779-800 (written while Moore was a Delaware Supreme Court Justice). They also have acknowledged the federal threat. See William T. Quillen, The Federal-State Corporate Law Relationship Response to Professor Seligman's Call for Federal Preemption of State Corporate Fiduciary Law, 59 BROOK. L. REV. 107, 129 (1993) (author is former Delaware Chancellor and Supreme Court Justice).

¹²⁴ The recent refusal of Delaware's judicial nominations committee to recommend the reappointment of Justice Andrew Moore, a judge with a reputation for solicitude for the shareholder interest, arguably confirms this point. See Richard B. Schmitt, Delaware Judge Is Seen as Investors' Friend, WALL ST. J., July 7, 1994, at B2.

¹²⁵ Slack results from monitoring costs that prevent interested parties from observing all actions taken by a regulator. To the extent slack is present, a regulator is more likely to be captured by an interest group; a self-interested regulator pursues public regarding policies only when little or no slack is present. See Levine & Forrence, *supra* note 47, at 183.

¹²⁶ For a reading of the post-Unocal cases along these lines, see Victor Brudney & William W. Bratton, *Brudney & Chirelstein's Cases and Materials on Corporate Finance* 1087-95, 1129-30 (4th ed. 1993).

already suggested that managers implicitly rely on the Delaware bar to represent their interests in the state. However, the bar's interests are far from perfectly aligned with management's, since litigation against managers also provides a source of income. Delaware has a unique collection of process rules that advance this local interest. These encourage derivative litigation,¹²⁷ making sure that the local bar gets a share of the action by requiring Delaware lawyers to make appearances and filings.¹²⁸ Competing demands also result in some systemic concessions to managers,¹²⁹ but the concessions hardly counter Delaware's reputation as a fee-generating center for corporate lawyers. The litigation rules thus stand as the great anomaly in the charter competition discussion, synchronizing with neither the race to the top¹³⁰ nor the race to the bottom.¹³¹

Jonathan Macey and Geoffrey Miller have explained the litigation rules with a supply-side account that highlights the impact of internal interest group politics on the production of Delaware law.¹³² In their account, all groups within the state have a common interest in producing a marketable legal regime, but the groups differ on the relative proportions of costs imposed and revenues earned. The taxpayers have an interest in higher direct costs (franchise tax revenues) and lower indirect costs (legal fees). The lawyers' interest in fees would be served by lower direct costs leading to a greater number of incorporations, and by higher indirect legal costs even sacrificing some incor-

¹²⁷ Delaware differs from many jurisdictions in not requiring plaintiffs in shareholder derivative actions to post security for expenses. See DEL. CT. C.P.R. 23.1. Delaware facilitates service of process on nonresident directors with a broad consent to service statute. See DEL. CODE ANN. tit. 10, § 3114 (1993). It also is liberal in its fee awards to derivative plaintiffs' lawyers: Under its nonpecuniary settlement practice, defending managers can trade a high fee for a small overall recovery. Coffee, *supra* note 28, at 763.

¹²⁸ See DEL. SUP. CT. R. 12(a) (1); DEL. CH. CT. R. 170.

¹²⁹ Delaware ameliorates the litigation rules' immediate impact on managers by allowing for liberal indemnification. Its courts also have been inventive in recent years in placing procedural barriers in the way of a trial on the merits of derivative claims. See *Aronson v. Lewis*, 473 A.2d 805, 813-14 (Del. 1984); *Zapata Corp. v. Maldonado*, 430 A.2d 779, 781-86 (Del. 1981). For criticism of these and subsequent cases, see Seligman, *New Corporate Law*, *supra* note 68, at 23-26. These defendant-friendly procedures do discourage litigation.

¹³⁰ Cary, who favored strict fiduciary-law control of management conduct, explained the rules as a special exception keyed to the interests of the Delaware bar. Cary, *supra* note 10, at 687.

¹³¹ Since the rules expand the zone of legal control of corporate actors for the benefit of lawyers, they arguably derogate from shareholder interests, viewed from the market deterrent point of view. See Macey & Miller, *supra* note 71, at 510-11.

¹³² *Id.* at 472.

porations when the legal fees paid exceed those lost. Macey and Miller assert that, unlike Delaware, a state acting as a pure profit maximizer would limit indirect costs to maximize direct costs.¹³³ Delaware fails to conform to the product model's predictions because the bar acts as a small, cohesive interest group that extracts special concessions from the legislature at the expense of the general public.¹³⁴

Macey and Miller rightly emphasize the organized bar's political power. Yet two factors that align the interests of the bar With those of the rest of the state need to be added to their description. First, the federal threat may temper the incentive of Delaware's lawyers to lobby for a reduction in direct charges to customers. Increasing Delaware's market share substantially above the level of one-half of public incorporations¹³⁵ would make Delaware even more of a national lawmaking center, enhancing its visibility and vulnerability to challenge at the national level. Given a state with a monopoly position, traditional federalism objections to intervention carry less weight. Second, rules that encourage litigation in Delaware play a secondary role in production. Delaware's case law and judges figure prominently in its substantive law product line.¹³⁶ Its code's advantages are less distinct than those of its cases, given statutory convergence among the states, but Delaware does not completely control the production of case law. The first option on the choice of the forum for new disputes tends to lie with the plaintiff, and in many instances Delaware law questions can be litigated in other states or in federal courts This gives Delaware a reason to offer incentives to plaintiffs. Their cooperation gives Delaware the opportunity to apply its own law, preserving the first-mover advantage and generating a flow of cases. These, in turn, are products sold in the charter market.

The need to satisfy the demands of the national plaintiff's bar reinforces the internal bargaining position of Delaware's bar, further explaining the state's delegation to the bar of the corporate legislative function.¹³⁷ However, the

¹³³ Id. at 498, 502-04.

¹³⁴ Id. at 506-09. Macey and Miller add an asymmetric information component to this market imperfection story. They draw on Romano's finding that lawyers (and to a lesser extent investment bankers) play key roles in reincorporation decisions and favor Delaware.

Id. at 486-87 (citing Romano, *Law as Product*, supra note 43, at 273, 275 n.72). They note that information problems on the clients' part may present a barrier to competition among the lawyers. Id. If the clients have an information problem, then we can account for Delaware's litigation rules as a shrewd marketing move—a boon to those responsible for making reincorporation decisions. Id. at 487.

¹³⁵ See supra note 43.

¹³⁶ See supra note 61 and accompanying text.

¹³⁷ See supra note 95 and accompanying text.

delegation to the bar also helps to stabilize the capture arrangement with management.¹³⁸

4.8 From Threatened Federal Intervention to Shareholder Intervention-The Strategy of Countervailing Interest Empowerment

The foregoing survey of the charter competition system highlights three points. First, although the system can be described as one of voluntary exchanges, that description does not by itself justify the system because these exchanges entail the capture of public authority. The states here effectively sell the coercive exercise of their authority on behalf of a purchasing group.¹³⁹ The system thereby lacks not only the exit possibilities presupposed by regulatory competition theory, but also the exit possibilities present when actors freely make contracts. Although the system affords relational benefits, it also channels distributions within the firms that enter into contracts with the states, making losers of the principals and winners of the agents. Second, the relative stability of the charter market cannot be completely accounted for with a relational contract model that recognizes only one possible route of defection by the state: defection to anticorporate interests opposed to the interests of both shareholders and managers. Contracts in the charter market are also structured to guard against state defection to the shareholder interest. In addition, in a federal system, state public authority, once captured, can be recaptured by a competing interest that manages to invoke federal authority.¹⁴⁰ Potential federal intervention makes this recapture a constant possibility in corporate law. Third, federal-state political instability can have wealth-enhancing properties. Under the conflicting demand model of Delaware law, the federal threat reinforces the shareholder voice, moving Delaware in the direction of shareholder value enhancement. The stronger the threat, the more pronounced the move.

Taken alone, however, the federal threat does not provide a workable basis for solving the corporate agency problem. Substantial political barriers to shareholder capture of federal authority keep the threat distant and make it possible for Delaware to defuse it with minimal concessions to the shareholders, while providing management with maximum feasible protection of its own prerogatives. Nor does this threat lend itself to institutionalization as a component of a federal intervention strategy designed to intensify the conflict-

¹³⁸ Thus, it may be that the conflict between Delaware's taxpayers and attorneys is either more nascent than actual or more settled than active.

¹³⁹ See Moe, *supra* note 42, at 123.

¹⁴⁰ See *id.* at 124.

ing demands on the states. Institutionalization implies the congressional mandate of a prospective and graduated scheme that ripens into preemptive mandates only to the extent that some background normative standard remains unsatisfied.¹⁴¹ Such a carrot-and-stick approach also implies a fully articulated federal corporate law policy. It is hard to imagine how such a scheme, once implemented on a national basis, would amount to anything short of blanket preemption that sacrifices the relational benefits of the state system.

Federal intervention nonetheless could help to place a stronger quantum of shareholder demand before state lawmakers. In regulatory theory, one expedient for the problem of agency capture by a producer group is consumer empowerment through the grant of standing in regulatory processes to public interest groups.¹⁴² This tripartite¹⁴³ strategy follows from the insight that the structuring of conflicts between agents, including third parties, can assist in the collection of information and the reordering of incentives in a desired direction.¹⁴⁴ Empowerment brings the representatives of the countervailing interest inside the system. Once inside, they assist legislative principals in overcoming the problem of asymmetric information in agency control. The countervailing interest generates information about the agency, supplementing the costly process of direct supervision.¹⁴⁵ Empowerment also reorders the incentives of the agents of the countervailing interest. Their inside position holds out an incentive to abandon obstructionist strategies and develop cooperative relationships with both regulators and producers. Ideally, they assist the evolution of win-win outcomes in the ongoing regulatory bargaining game.¹⁴⁶

¹⁴¹ Under this 'big stick' theory of regulation, the regulatory authority makes self-regulation generally available, but holds out a graduated threat of command and control regulation and punishment for uncooperative parties, thereby building in an incentive to comply. See Ayres & Braithwaite, *supra* note 13, at 39-40 (discussing the theory in the administrative law context).

¹⁴² In Ayres and Braithwaite's model of 'tripartitism', the public interest group receives the same information as the regulator, a seat at the negotiating table, and equal standing. Ayres & Braithwaite, *supra* note 13, at 57-58.

¹⁴³ 'Tripartite' is used *id.* at 57-60.

¹⁴⁴ Laffont & Tirole, *supra* note 91, at 611.

¹⁴⁵ Mathew D. McCubbins & Thomas Schwartz, *Police Patrols v. Fire Alarms*, 28 AM. J. POL. SCI. 165, 166 (1984), distinguished between 'police patrol' oversight, direct monitoring of the agent by the principal, and 'fire alarm' protection, a passive form of oversight in which third parties bear the bulk of the cost of providing information. This model was extended in Arthur Lupia & Mathew D. McCubbins, *Learning from Oversight: Fire Alarms and Police Patrols Reconstructed*, 10 J.L. ECON. & ORGS. 96, 105 (1994), with a model of a multistage, single-shot two person game involving a principal and an agent, showing how the principal learns from fire-alarm oversight.

¹⁴⁶ Ayres & Braithwaite, *supra* note 13, at 71-73.

Finally, since these public interest figures attain their status as agents in the world of grassroots politics, they are relatively unsusceptible to capture. Since their guardianship positions are contestable, reputational incentives make defection to competing interests unlikely.¹⁴⁷

The strategy of countervailing interest empowerment shares objectives with the strategy of regulatory competition. Both seek regulatory flexibility and balanced control of regulatory structures that deter the capture of regulators.¹⁴⁸ The choice between the two may depend in part on the situation. Regulatory competition theory assumes that competition provoked by exit frees the regulator from interest group control. Interest group empowerment addresses the capture problem where competition either has been blocked by regulatory coordination, or, as has occurred in the case of corporate law, has served as a mechanism to enforce the capture arrangement.

The often-suggested corporate law reform that we revive here shareholder initiative to amend the charter and effect reincorporation-is the corporate law equivalent of an interest group empowerment strategy. The avenue of shareholder initiative makes it possible for the shareholders to make competing demands on the states themselves, and thereby gain a seat at the table when state laws are formulated. The problem with this strategy, of course, is the problem of shareholder collective action. However, as the next part shows, the gravity of that problem has diminished.

III. STRATEGIES FOR ENFORCED SELF-REGULATION THROUGH SHAREHOLDER PARTICIPATION

Concentrated institutional ownership holds out the possibility that shareholders can surmount collective action barriers keeping them from governance participation. Shareholder participation, in turn, holds out the possibility of a transition from voluntary to enforced self-regulation as shareholders use their votes to revise the process terms of corporate contracts or to place capable and independent monitors on the board. Enforced self-regulation, in turn, holds out the possibility of cooperative gain through relational engagement. The short-term, arm's length engagement of the shareholder under a deterrent regime evolves into the long-term, patient commitment of an equity partner.¹⁴⁹ In theory, this resolves governance conflicts of the 1980s: Effective

¹⁴⁷ *Id.* at 73.

¹⁴⁸ See *id.* at 59, 71.

¹⁴⁹ See Ayres & Cramton, *supra* note 19, at 1038; Jeffrey N. Gordon, Institutions as Relational Investors: A New Look at Cumulative Voting, 94 COLUM. L. REV. 124, 129

monitoring reduces the gap between market and intrinsic value that triggers hostile intervention by market means.¹⁵⁰

This relational model's realization depends in part on the alignment between governance benefits and the incentives of institutional agents. This part describes these incentive problems and identifies the strategies for their solution. In theory, financial benefits themselves provide sufficient incentives, given the removal of legal barriers to group action. In practice, shareholder intervention has been effected by a group of political entrepreneurs, the agents of public pension funds, who appear to be pursuing reputational gain.

4.9 The Collective Action Problem, the Cost-Benefit Solution, and the Counter Story

Historically, shareholders of public companies are an Olsonian latent group.¹⁵¹ That is, a collective good-active monitoring of management-would make them better off given proportionate distribution of its costs, but the law provides no cost-sharing mechanism, and the free-rider problem prevents the emergence of a volunteer or group of volunteers with an incentive to provide the good.¹⁵² Given dispersed shareholdings, the nontrivial costs of active monitoring, and the alternative of exit through sale, the benefits obtainable without investment in monitoring exceed the benefits obtainable from investment.¹⁵³ In addition, rational apathy prevails when the system mandates that matters be presented for shareholder approval. The rational small shareholder does not invest in information about governance matters, given the likelihood that the collective action problem inhibits an effective group response.¹⁵⁴

Collective action theory allows for the possibility that a subgroup of a latent group will organize and provide the public good if the benefits from action to each member of the subgroup exceed the costs incurred.¹⁵⁵ The increased

(1994) [hereinafter Gordon, Cumulative Voting].

¹⁵⁰ See Ronald J. Gilson & Reinier Kraakman, Investment Companies as Guardian Shareholders: The Place of the MSIC in the Corporate Governance Debate, 45 STAN. L. REV. 985, 1006-49 (1993) [hereinafter Gilson & Kraakman, Investment Companies].

¹⁵¹ See Edward B. Rock, The Logic and (Uncertain) Significance of Institutional Shareholder Activism, 79 GEO. L.J. 445, 455-59 (1991) [hereinafter Rock, Shareholder Activism] (working the models of Olson and Hardin through the corporate fact pattern).

¹⁵² Each member of the group rationally prefers that others in the group incur the costs of providing the public good.

¹⁵³ Rock, Shareholder Activism, *supra* note 150, at 455-56.

¹⁵⁴ See Grundfest, *supra* note 32, at 910.

¹⁵⁵ Rock, Shareholder Activism, *supra* note 150, at 457-59 (citing Russell Hardin, *Collective Action* 41 (1982)).

concentration of shareholdings in institutional hands makes it conceivable that institutional subgroups might find investment in monitoring cost beneficial.¹⁵⁶ Concentration of shares also promises to mitigate the rational apathy problem. The shareholders' decision of whether to seek information about the governance issue depends on the costs and expected benefits of the effort and the initiative's probabilities of success. The cost is independent of the number of shares held. With individual shareholders holding larger proportionate stakes in the firm, the expected returns from a given information investment go up, as does the proponent's chance of success.¹⁵⁷

Subgroup formation depends on the size of the group, the cost of action, and the magnitude of the benefit the subgroup seeks. Proponents of law reform designed to facilitate shareholder participation direct most of their attention to the first two factors. Since the number of members needed to form a subgroup declines as ownership concentration goes up, the proponents argue for a relaxation of the regulatory barriers that impede the accumulation of large holdings in given firms by single investors or organized groups of investors.¹⁵⁸ The proponents also circulate blueprints for cheap strategies, since, as the costs of a given initiative go down, subgroup formation can go forward with a lower level of concentration and a lower projected probability of success.¹⁵⁹

In sum, the proponents assert that, given certain legal adjustments, prospects for financial gain by themselves will induce governance initiatives by institutional investors. Yet there is a counter story. This asserts that, even with legal adjustments, governance initiatives realizing the full promise of cooperative gain through enforced self-regulation cannot be expected. Two points are emphasized. First, agency relationships within investment institutions create disincentives that prevent subgroup formation, even assuming a projection of a positive return to the subgroup from an investment in governance. Since the individual manager's performance is measured against the performance of the

¹⁵⁶ *Id.* at 459. As Black argues, shareholder passivity may be historically contingent, the result of a combination of legal obstacles and past dispersed ownership patterns. See Bernard S. Black, *Shareholder Passivity Re-examined*, 89 MICH. L. REV. 520, 525 (1990) [hereinafter Black, *Shareholder Passivity*].

¹⁵⁷ According to Black, the incentive to become informed increases as the holder's share ownership level is squared. *Id.* at 585-89.

¹⁵⁸ *Id.* at 578.

¹⁵⁹ See Grundfest, *supra* note 32, at 908-13 (examining the minimum cost strategy of the 'just vote no' campaign). Proponents of reform also stress that scale economies lie in the application of a single governance device to multiple companies, Black, *Shareholder Passivity*, *supra* note 155, at 584, and argue for rules that transfer the cost of shareholder initiatives to the firm, see *id.* at 579-80.

market as a whole and subgroup investment benefits the market as a whole, successful governance investments do not necessarily improve the individual manager's performance profile.¹⁶⁰ Second, the benefits of cost-intensive relational investment remain underspecified. In theory, these lie in informational access and ongoing constructive criticism by the institutional monitor.¹⁶¹ In practice, underperforming companies are publicly identified in the ordinary course, and standard remedies respecting investment policies, incentive schemes, and governance structures are part of the conventional wisdom. To the extent that institutions can cheaply tie the communication of these points to credible threats against target managers, they can secure the available set of governance benefits through a discrete engagement. Incentives for more substantial investments in ongoing relationships remain speculative, absent a special technical capability on the part of the particular monitor. As a result, risks of perverse incentives and commitment problems come to the forefront of the relational picture. A strategically placed institutional holder could opt for side payments from management in preference to public-regarding informational development, or, given a hostile tender offer, the institutions in the subgroup could defect from an implicit undertaking by management to be patient.¹⁶²

The practice has tended to fulfil the counter story's predictions. Relational engagements have been discrete, cheap, and focused on the short term. In contrast to the proponents' prediction that financial incentives by themselves will induce subgroup formation, the selective incentive of reputation seems to drive the practice. This implies that contractual renegotiation of governance terms will dominate over direct monitoring of investment decision-making as the means to enhance value through shareholder participation.

¹⁶⁰ Rock, Shareholder Activism, *supra* note 150, at 473-74; see also Jill E. Fisch, Relationship Investing: Will it Happen? Will it Work?, 55 OHIO ST. L.J. 1009, 102-25 (1994) (arguing that competitive pressures on institutional performance must be accounted for in cost-benefit models of institutional monitoring); Helen Garten, Institutional Investors and the New Financial Order, 44 RUTGERS L. REV. 585, 631-32 (1992) (arguing that it is difficult to increase institutional activism).

¹⁶¹ See *infra* note 217. It comes as no surprise that the results of empirical studies of returns on monitoring activities are inconclusive. See Fisch, *supra* note 159, at 1035 (citing Lilli A. Gordon and John Pound, *Active Investing in the U.S. Equity Market: Past Performance and Future Prospects, Report for the California Public Employees' Retirement System* 44 (Jan. 11, 1993)).

¹⁶² For exploration of these problems, see Ayres & Cramton, *supra* note 19, at 1036-39; Edward B. Rock, Controlling the Dark Side of Relational Investing, 15 CARDOZO L. REV. 987, 989-99 (1994) [hereinafter Rock, Dark Side].

4.10 Selective Incentives and the Pattern of Shareholder Participation

4.10.1 The Pattern of Discrete Intervention

Institutional investor activism is the successful grassroots political movement of American big business. It began during the late 1980s when institutions became dissatisfied with expanding legal constraints on takeover activity. The access route was the precatory shareholder proposal,¹⁶³ a medium for non-binding, shareholder-initiated voting proposals made available by preemptive mandate under the federal proxy rules.¹⁶⁴ The first generation of proposals

¹⁶³ Management must include in the annual proxy statement precatory shareholder proposals that meet Rule 14a-8 process and suitability guidelines. Proxy Solicitation Rules, 17 C.F.R. § 240.14a-8 (1994).

The process guidelines, set out in Rule 14a-8(a)(2) to (4), are strict—the proponent is allowed only one proposal, submission must occur months before the meeting, and the supporting statement is limited to 500 words. 17 C.F.R. § 240.14(a)-8(a)2 to 3 (1993). The suitability guidelines are stricter. They were drafted at a time when shareholder proposals were envisioned as a medium for expression of concern on social issues related to corporations, and exclude many business topics of prime concern to governance activists. To wit, under Rule 14a-8(c), matters of ‘ordinary business operations’, ‘election(s) to office’, proposals counter to management proposals, and ‘specific amounts of cash ... dividends’ are unsuitable; at the same time, a social proposal ‘not . . . significantly related’ to the business also is unsuitable. 17 C.F.R. § 240.14a-8(c)5, 7-9 & 13 (1994).

The SEC alters its interpretations of these rules from time to time, opening the door to issues concerning the operation of the business if it determines that the particular topic has taken on substantial policy import. The Commission has not been notably consistent in these determinations. Compare *Cracker Barrel Old Country Store, Inc.*, SEC No-Action Letter, (1992-1993 Transfer Binder) Fed. Sec. L. Rep. (CCH) ¶ 76,418, at 77,284-87 (Oct. 13, 1992) (finding unsuitable a proposal recommending policy of nondiscrimination respecting sexual preference in hiring), with *Eli Lilly & Co.*, SEC No-Action Letter (1993 Transfer Binder) Fed. Sec. L. Rep. (CCH) ¶ 76,629, at 77,682 (Feb. 25, 1993) (finding suitable a proposal recommending adoption of price restraint policy by drug company suitable) and *AT&T*, 1990 SEC No-Act LEXIS 20, *2.3 (Jan. 5, 1990) (finding proposal for elimination of affirmative action programs suitable). This sort of nonsense has gotten the agency into difficulties with certain courts. See *New York City Employees' Retirement Sys. v. SEC*, 843 F. Supp. 858 (S.D.N.Y. 1994) (enjoining the agency from acting inconsistently with its own stated policy in respect to the *Cracker Barrel* proposal), *rev'd*, Fed. Sec. L. Rep. (CCH) ¶ 98,493 (2d Cir. Jan. 3, 1995).

Observers tend to see these suitability rules as manifestly unsatisfactory. See, e.g., Black, *Shareholder Passivity*, *supra* note 155, at 541; Jill E. Fisch, *From Legitimacy to Logic: Reconstructing Proxy Regulation*, 46 *VAND. L. REV.* 1129, 1155-2 (1993).

¹⁶⁴ Under Rule 14a-8, the proponent bears the expense of making the proposal, including legal expenses in the event of a management challenge to its suitability, but the corporation

concerned poison pills, and urged management to exercise its privilege of redeeming them or to submit them to shareholder approval.¹⁶⁵ The first sustained assault on the pills came in 1987, when a group of public pension funds discovered the economy of scale and submitted proposals at forty firms. The proposals received more than twenty percent of the votes cast-significant returns given the historic pattern of overwhelming votes against shareholder proposals.¹⁶⁶

The activists thereafter broadened the range of their proposals to cover other takeover defenses¹⁶⁷ and, with proposals for confidential voting, the voting process itself.¹⁶⁸ By 1990, the voting pattern had changed. In that year, 160 shareholder proposals received more than twenty percent of the votes, and nineteen received more than fifty-percent¹⁶⁹ the largest number of successful proposals in the entire history of the device.¹⁷⁰ The voting pattern respecting

bears the expense of including the proposal in the proxy statement. Proxy Solicitation Rules, 17 C.F.R. § 240.14a-8 (1994).

¹⁶⁵ Gilson & Kraakman, *Institutional Agenda*, supra note 32, at 867-8.

¹⁶⁶ Rock, supra note 150, at 402. The players were the College Retirement Equities Fund, the California Public Employees Retirement System, and the Wisconsin Investment Board, loosely organized through the Council of Institutional Investors. Jayne W. Barnard, *Institutional Investors and the New Corporate Governance*, 69 N.C. L. REV. 1135, 1153 (1991).

Mark R. Wingerson & Christopher H. Dorn, *Institutional Investors in the U.S. and the Repeal of Poison Pills: A Practitioner's Perspective*, in *Institutional Investors and Corporate Governance*, supra note 11, at 201-02, makes a counter suggestion. Given the present control market in which takeovers tend to be strategic moves made by larger players in a given industry, they argue that the shareholders' interest lies in leaving the pills in place to facilitate lowercost friendly transactions. *Id.* at 212. They thus ascribe institutional pressure for pill redemption entirely to selective incentives. *Id.* at 211-22.

¹⁶⁷ The proposals suggested prohibition (or requirement of shareholder approval) of greenmail payments, opting out of antitakeover statutes, and requiring shareholder approval of placements of large blocks of stock with management-friendly holders. See Gilson & Kraakman, *Institutional Agenda*, supra note 32, at 868.

¹⁶⁸ See Black, *Agents*, supra note 30, at 825-26. Confidential voting assists shareholder participation in two ways. First, confidentiality prevents management from punishing private investment institutions that vote against it in the product market. *Id.* Second, under the usual procedures, management's proxy solicitors are free to count the proxies as they come in, identify no-voting shareholders, and resolicit their votes. If the vote seems destined to go against management, management can withdraw its proposal. Shareholder proponents do not have this privilege. *Id.*

¹⁶⁹ Rock, *Shareholder Activism*, supra note 150, at 483.

¹⁷⁰ Barnard, supra note 165, at 1156. Poison pill proposals received an average vote of 42%. Black, *Agents*, supra note 30, at 828.

management proposals also had changed.¹⁷¹ Although the overwhelming majority management proposals submitted in 1990 were approved, ten were defeated and two were withdrawn to avoid defeat.¹⁷² Anti-takeover charter amendments, overwhelmingly approved in the early 1980s, now passed with only fifty to sixty percent of the vote.¹⁷³

Institutional activists had arrived, led by agents of the California Public Employees Retirement System (CalPERS) and other public pension funds. After 1990, the subject matter of their proposals broadened again, to include process and structure proposals designed to make boards more effective in monitoring and designing incentive arrangement.¹⁷⁴ More importantly, success caused the set of cheap strategies to expand. It turned out that managers, once confronted with majority or near majority votes for the institutions' nonbinding proposals, or confronted with even the prospect of such a vote,

¹⁷¹ Management must submit charter amendments and fundamental corporate changes, including liquidation, substantial asset sales, and some mergers for a shareholder vote. See DEL. CODE ANN. tit. 8, §§ 242, 251, 271, 275 (1994). Executive compensation plans must be submitted to the shareholders pursuant to exchange listing rules.

¹⁷² Rock, Shareholder Activism, *supra* note 150, at 484.

¹⁷³ Black, Shareholder Passivity, *supra* note 155, at 571.

¹⁷⁴ Suggested improvements included the separation of the functions of board chairman and chief executive officer and outside director membership for the compensation committee. Proposals respecting executive pay also appeared, after the SEC reversed a position in 1992 and declared the subject matter to be proper under its rule. See Staff Advises Shareholder Proposals on Pay Includible in Proxy Materials, 24 SEC. REG. & L. REP. (BNA), No. 8, at 250 (Feb. 21, 1992). Shareholder intervention has resulted in changes in compensation practices at ITT, IBM, Cincinnati Bell, and Avon. Grundfest, *supra* note 32, at 931.

Institutional shareholder proposals continue to increase in number. See 9 CORP. COUNS. WKLY (BNA), No. 22, at 4 (June 22, 1994) (reporting a slight increase in 1993 and 1994). In the 1994 annual meeting season (according to Georgeson & Co.), institutions sponsored 69 proposals, up from 65 in 1993. *Id.* Of the 1994 proposals, 11 sought to repeal classified boards, 10 concerned executive compensation, 7 sought poison pill redemption, and 14 advocated confidential voting. '93- '94 Proxy Seasons Said to Show Slight Increase in Shareholder Activism, 9 CORP. COUNS. WKLY (BNA), No. 24, at 4 (June 22, 1994) [hereinafter '93- '94 Proxy Seasons]. There has been a change in the sponsorship pattern, however. Labor unions have appeared as sponsors, backing 32 proposals in 1994 versus 9 in 1993. John C. Wilcox, chairman of Georgeson & Co., characterizes the unions as 'gadflies', because they repeat their proposals and do not seek to negotiate with management before submitting them. *Id.* In another recent development, CalPERS, citing an independent consultant's stock price study, has indicated an interest in encouraging management to adopt 'high performance' workplace strategies that accord workers more rights and feedback. See *id.* at 1.

proved willing to open negotiations and make concessions,¹⁷⁵ either by voluntarily adopting responsive measures or by accepting other policy changes in exchange for the withdrawal of a proposal.¹⁷⁶ Proponents took this advantage and gained negotiating access by generating bad publicity without making specific proposals. They publicized lists of underperforming companies¹⁷⁷ with the suggestion that shareholders 'just vote no' in that year's board election.¹⁷⁸

Proponents then would meet with management to voice their criticisms and concerns. Results followed¹⁷⁹ — chief executives were terminated at two of CalPERS' 1992 targets, IBM and Westinghouse; another target, Sears, took the institutions' advice about concentrating on the core business and dismembered itself.¹⁸⁰ A change in the SEC proxy rules, promulgated in 1992 as

¹⁷⁵ See Rock, *Shareholder Activism*, *supra* note 150, at 483. For example, K-Mart accepted two proposals in 1990 and seven firms instituted confidential voting in exchange for withdrawal of proposals. *Id.*

¹⁷⁶ Grundfest, *supra* note 32, at 932 (stating that in 1992, 31 firms confronted with shareholder proposals negotiated their withdrawal). Institutional successes also have had a noticeable deterrent effect on management proposals for self-protective charter amendments. See Black, *Agents*, *supra* note 30, at 828-29.

¹⁷⁷ See CalPERS Lists 12 Companies in Effort to Focus Attention on Corporate Reform, 24 SEC. REG. & L. REP. (BNA), No. 13, at 420 (Mar. 27, 1992).

¹⁷⁸ Grundfest, *supra* note 32, at 933. The New York State Common Retirement Fund, the Public Employees Retirement Fund of Colorado, the New York State Local Retirement Funds, the New York City Retirement Systems, and CREF have joined CalPERS in these campaigns. *Id.* at 867 & n.37.

Grundfest notes the cost advantages of these dialogic campaigns. The analysts collect the basic information on performance and the costs of drafting and compliance costs of 14a-8 proposals are avoided. CalPERS estimates that a 14a-8 proposal can cost up to \$500,000, where a 'just vote no' campaign costs \$100,000. *Id.* at 911-12. However, the device is not necessarily more effective than the alternative of a precatory shareholder proposal directed to a matter of process and structure; the latter gained stronger support than the former at the 1995 annual meeting of Philip Morris, a current institutional target. See *infra* note 2%.

¹⁷⁹ *Id.* at 933. Heads also have rolled at Goodyear, Allied Signal, Tenneco, Shearson, and Kodak. *Id.* at 882-94.

¹⁸⁰ This sort of institutional pressure continued to be exerted through 1994, with different results in different firms. K-Mart and Philip Morris were two leading institutional targets. At K-Mart, institutions pressuring for the separation of non-core retailing divisions caused the defeat of a company proposal (presented for approval at the annual meeting) deemed not to go far enough. Months later, the board removed the embattled C.E.O. from the chairmanship, but it retained him as president. See Joann S. Lublin & Christina Duff, *Management How Do You Fire a CEO? Very, Very Slowly*, WALL. ST. J., Jan. 20, 1995, at B1. Philip Morris experienced similar institutional pressure for division of the company,

a result of institutional pressures, facilitated the new approach by permitting shareholders to publish their views in the media without prior agency approval.¹⁸¹

4.10.2 Explaining and Evaluating the Pattern

The institutional shareholders' record, thus outlined, confirms that concentrated shareholders are not passive and can coordinate votes to achieve results. Specifically, the rational apathy problem has diminished substantially, reputational threats against managers have proved effective, and capture of institutional proponents has not been a problem. Diverse incentives among the institutions, however, make the wider attack on the collective action barrier a tentative one.

4.10.2.1 *The Rational Apathy Problem*

The rational apathy calculation broke during the 1980s when newly concentrated holders encountered takeover-related voting issues with substantial financial implications.¹⁸² Institutions thereafter made at least minimal investments in information on governance issues and showed some discrimination in their voting.¹⁸³ The network of activist institutions also became a point

but the internal politics worked differently. See *infra* note 2%.

¹⁸¹ See Proxy Solicitation Rules, 17 C.F.R. § 240.14a-2(b)(1) (1994). The earlier rules prohibited solicitation of more than 10 other shareholders without advance clearance. The revised rules also cut back on management agenda control in the proxy solicitation itself by (1) permitting shareholders to vote in board elections for a combination of management nominees and outside challengers, and (2) allowing shareholders to oppose a single management proposal without being required to vote for or against an entire slate of proposals. 17 C.F.R. § 240.14(a)-4(b) (1994). The former change facilitates the possibility of campaigns for select numbers of institutionally nominated directors. See Ronald J. Gilson et al., *How the Proxy Rules Discourage Constructive Engagement: Regulatory Barriers to Electing a Minority of Directors*, 17 J. CORP. L. 29, 33-42 (1991). The latter change prevents the bundling of a proposal to which shareholders might object with an advantageous proposal. It does not, however, prevent management from conditioning the approval of a proposal on the approval of one or more other proposals. See Fisch, *supra* note 162, at 1169-70.

The revised rules have had some effect on the pattern of proxy contests. Institutions now solicit proxies from one another when opposing mergers or corporate restructurings. See '93-'94 Proxy Seasons, *supra* note 173, at 2.

¹⁸² On this point, then, Black's 'critical mass' has been reached. See Black, *Shareholder Passivity*, *supra* note 155, at 588-89.

¹⁸³ The institutions articulate voting policies in advance by type of proposal. See Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93

of information exchange. Their public suggestions that votes in selected firms be tied to performance entail the sorting of financial information for rechanneling into the voting arena. This ameliorates a problem of Informational slack¹⁸⁴ in addition to securing leverage for negotiations. Finally, the activists' success at extracting governance concessions provided the wider institutional community with ongoing incentives to stay informed, even as takeover-related incentives declined in importance after 1989.

4.10.2.2 *The Reputational Threat*

The record also suggests a revision of the standard list of corporate governance deterrents. As yet, most shareholder initiatives have not employed threats of direct intervention in the form of mandatory proposals¹⁸⁵ or opposing slates of directors.¹⁸⁶ Instead, action is communicative. The shareholders as a group are invited to join in a nonbinding request and their cooperation indicates dissatisfaction with performance.¹⁸⁷ In the alternative, the proponent announces performance dissatisfaction directly and invites others to concur. None of these initiatives entails a takeover threat in the present climate.

COLUM. L. REV. 795, 831-39 (1993) [hereinafter Romano, Pension Fund Activism] (comparing public and private fund voting policies). But cf. Louis Lewenstein, Why Managements Should (And Should Not) Have Respect for Their Shareholders, 17 J. CORP. L. 1, 19-20 (1991) (surveying the guidelines of one bank and finding that they crudely fail to discriminate between well and badly run companies to avoid an appearance of favoritism to bank customers).

¹⁸⁴ See Levine & Forrence, *supra* note 47, at 185-91. CalPERS's list of underperforming firms amounts to a 'fire alarm' mode of oversight that supplements the 'police patrolling' of the independent directors. See McCubbins et al., *supra* note 89, at 273-74. The fire alarm realigns the outside directors' incentives to make them more inclined to challenge the managers. *Id.*

¹⁸⁵ These are prohibitively costly under state law, and the extent to which the proxy rules allow for them under Rule 14a-8 is unclear. See *infra* note 274 and accompanying text.

¹⁸⁶ Dissident investors have successfully conducted proxy contests for board seats in a handful of cases. See John Pound, The Rise of the Political Model of Corporate Governance and Corporate Control, 68 N.Y.U. L. REV. 1003, 1047-50 (1993).

¹⁸⁷ It is not clear how discriminating the institutional voters are in this regard. Confidential voting, once placed as a yes vote in a guideline presumably results in yes votes in both well and badly managed companies. See Lowenstein, *supra* note 182, at 19-20. The value of the signal depends on the discrimination of the activist gatekeeper. At least one writer has assured managers that shareholder initiatives can be avoided through good financial performance over the long run and direct explanation of any short-term problems to the institutions. Robert C. Pozen, Institutional Investors: The Reluctant Activists, HARV. BUS. REV. 141, 147A9 (Jan.-Feb. 1994).

Nevertheless, they result in preemptive negotiations and concessions by managers,¹⁸⁸ and, in some cases, prompt the termination of the chief executive by the outside directors.

These shareholder threats appear credible because they impact on the reputational interests of chief executives and independent board members. The campaign declares that the target executives possess undesirable characteristics,¹⁸⁹ detracting from their standing in the business community¹⁹⁰ and, in some cases, from their marketability. It can be expected that managers will be extraordinarily risk-averse to such reputational impairment if, as seems reasonable, we can assume that employment contracts are incomplete and do not fully compensate for tenure insecurity and the costs of changing jobs.¹⁹¹ Preemption by negotiation serves the managers' interest by defusing the threat and providing them with some control over the settlement process.¹⁹²

More broadly, the appearance of a vocal shareholder interest group changes the manager's institutional environment. The institutions articulate a normative challenge to the manager's conduct of the business.¹⁹³ Their challenge has a more destabilizing effect than ordinary external criticism, due to their equity investments, long term presence, and ability to marshal votes respecting both present and future matters for shareholder action. They represent an unstable sector in the larger domain of institutional relationships with which the manager deals.¹⁹⁴ By negotiating, the risk-averse manager¹⁹⁵ seeks to stabilize

¹⁸⁸ Pound, *supra* note 185, at 1057-61.

¹⁸⁹ Grundfest, *supra* note 32, at 927-28.

¹⁹⁰ See James G. March & Zur Shapira, *Managerial Perspectives on Risk and Risk Taking*, 33 *MGMT. SCI.* 1404, 1413 (1987) (stating that managers are concerned about their reputations for risk-taking and are eager to discuss the deficiencies of others).

¹⁹¹ See Milgrom & Roberts, *supra* note 2, at 158-62.

¹⁹² See Gilson et al., *supra* note 180, at 45.

¹⁹³ Firms are, from a sociological perspective, normative environments. Institutional norms are rationalized prescriptions that identify social purposes as technical ones and specify rule-like means to pursue these technical rationalities. John W. Meyer & Brian Rowan, *Institutional Organization: Formal Structure as Myth and Ceremony*, 83 *AM. J. SOC.* 340, 343-44 (1977).

¹⁹⁴ See Walter W. Powell & Paul J. DiMaggio, *The New Institutionalism in Organizational Analysis* 30 (1991) (looking to extra-institutional sources of institutional change as a complement to the internal interest group story of the firm).

¹⁹⁵ See March & Shapira, *supra* note 189, at 1410-14 (suggesting that extreme risk aversion can be expected). March and Shapira survey empirical studies on attitudes to risk and conclude (1) that the managers do not see uncertainty about positive outcomes as an important part of risk, and rather understand risk in terms of negative outcomes; and (2) that managers do not understand risk as a probability concept, instead understanding risk in terms of how much they might lose rather than the probability of loss. *Id.* at 1407. See

and influence the relationship.

The shareholder threat can also destabilize the relationships of inside managers and outside directors by reorienting the outsiders' incentives.¹⁹⁶ Ordinarily, the outside directors, being corporate players themselves,¹⁹⁶ see that their interests lie in cooperation with management. However, shareholder intervention gives rise to a public question about the outsiders' effectiveness, creating a dual demand that has an impact on different components of the same reputation. If the conflict becomes severe, the outsiders resolve it by forming a coalition and exercising their board voting power to oust the chief executive. Thus, publicity and reputational interests combine to effect a transfer of control.

The occurrence of a number of such transfers in practice bolsters the activists' credibility. These cases also represent an important achievement: Since managers become psychologically invested in their past strategies, chief executive turnover plays a crucial role in prompting disinvestment in those strategies.¹⁹⁷ Furthermore, organizational tenure has been accorded a principal role in explaining the informational diversity, risk, and status quo preferences of the teams of managers that run corporations. Long-term executives tend to employ unchanging strategies and rely on customary information sources. Teams with short tenures are more inclined to adopt diverse strategies, look for new sources of information, and develop new plans.¹⁹⁸

generally Kenneth R. MacCrimmon & Donald A. Wehrung, *Taking Risks: the Management of Uncertainty* 77-274 (1986) (reporting on a comprehensive survey of senior business executives and studying their willingness to take risks).

¹⁹⁶ See supra text accompanying note 15.

¹⁹⁷ See Theresa K. Lant et al., The role of Managerial Learning and Interpretation in Strategic Persistence and Reorientation: An Empirical Exploration, 13 STRATEGIC MGMT. J. 585, 588, 603 (1992) (stressing that heterogeneity of top management induces strategic change and that managers in environments with constant change are more likely to change than others in less complex circumstances); see also Paul C. Nystrom & William H. Starbuck, To Avoid Organizational Crises; Unlearn, *Organizational Dynamics*, Spring 1984, at 53-60 (explaining that faulty cognitive structures developed by top managers contribute to an organization's inability to deal with crisis, often requiring an infusion of new ideas in the form of new managers).

¹⁹⁸ See Sydney Finkelstein & Donald C. Hambrick, Top Management-Team Tenure and Organizational Outcomes: The Moderating Role of Managerial Discretion, 35 ADMIN. SCI. Q. 484, 486-88 (1990); see also Jeffrey Pfeffer, Organizational Demography, in 5 *Research in Organizational Behavior* 299, 320-26 (L.L. Cummings & Barry M. Staw eds., 1983) (examining the effects of organizational demography on innovation, adaptation and performance). But see Andrew M. Pettigrew, On Studying Managerial Elites, 13 STRATEGIC MGMT. J. 163 passim (1992) (providing a methodological critique of this literature).

4.10.2.3 *Financial and Selective Incentives*

Shareholder engagements have followed a discrete, single-shot pattern. Agents of public and not-for-profit funds take the initiative, select targets, and make investments in communication and legal compliance. Private sector agents of mutual funds, private pension funds, management firms, banks and insurance companies follow the leaders,¹⁹⁹ taking a selective, cost-sensitive approach. Larger private players join in the dialogue when prominent underperforming companies become successful targets. Otherwise, they discriminate among specific issues according to projected short-term financial consequences. A proposition with significant bearing on short-term returns, such as a management proposal for a merger with a low payout, might prompt an initiative. Other issues will not, with the extent of participation in the initiatives diminishing with the payoff: Poison pills rank above compensation plans, which in turn rank above more general process and structure improvements.²⁰⁰

This division of functions between public and private institutions follows from differences in the agents' financial incentives and the institutions' product market vulnerabilities. Public pension funds tend to be internally managed by civil servants who have relative immunity to threats by managers. These agents' bureaucratic positions also lead them to pursue risk averse financial strategies, since the public sector provides no special rewards for exceptional financial performance, while financial failure can lead to punishment.²⁰¹ These funds, as a result, are heavily indexed.²⁰² Private sector agents, in contrast, run the risk of management punishment for uncooperative conduct.²⁰³ They also have stronger incentives to pursue upside gain, which leads them to trade more actively and worry about liquidity.²⁰⁴ Some also

¹⁹⁹ In 1990 public pension funds owned 8.3% of the equity market; private pension funds owned 19.9%; mutual funds owned 7.2%. All of these percentages had increased by 1992. See Coffee, Half-Time Report, *supra* note 32, at 848-49.

²⁰⁰ Pozen sets out this pattern of response. Pozen, *supra* note 186, at 145-46.

²⁰¹ See Lowenstein, *supra* note 182, at 17-18.

²⁰² See Coffee, Half-Time Report, *supra* note 32, at 860.

²⁰³ See, e.g., Grundfest, *supra* note 32, at 913-24. Corporations, particularly corporate pension funds, are a significant source of business for private managers. A well-publicized confrontation with one management group can chill a business relationship with a similarly situated group. *Id.*

²⁰⁴ Private pension funds tend to be 'defined benefit' plans, giving the corporate sponsor an incentive to maximize plan return to minimize the need for corporate contributions. Public plans sometimes follow a 'defined contribution' pattern, with no connection between performance and contribution. Coffee, Half-Time Report, *supra* note 32, at 859. Romano suggests that possibilities for external political pressures on public pension fund agents

work under tight cost constraints that stem from fee arrangements structured on the assumption of governance passivity.²⁰⁵

The different behavior patterns of public and private institutions reverse the assertion of the financial incentive theory 'of shareholder participation. In theory financial gain provides the incentive, while in practice the less intense the financial pressures on the agent, the greater the likelihood that the agent will take the governance initiative.²⁰⁶ This odd result dovetails with the more general point that inevitable sharing of governance gains with free riders makes governance investment irrational in a world in which the agent's individual performance evaluation proceeds against the performance of the market as a whole.²⁰⁷ Together these points confirm the prediction that shareholder initiative will follow from selective incentives. Public sector actors, as civil servants, are unimpeded by the private actors' cost, product market, and reputational disincentives. At the same time, governance activity seems to suit them as a mode of reputation enhancement. Given this phenomenon of reward for power exercised over business actors rather than for financial performance,²⁰⁸ they are political entrepreneurs in both the traditional and Olsonian senses.²⁰⁹

would diminish if all took the defined contribution form. Romano, Pension Fund Activism, *supra* note 182, at 844-51.

²⁰⁵ Pozen cites 70 basis points per year plus a maximum performance fee of 10 to 20 basis points for external managers, and notes that all costs of dealing with the proxy process come out of this compensation pool. Pozen, *supra* note 186, at 144.

²⁰⁶ There is a counter story to the effect that the indexed investor must invest in systemic governance improvements due to the absence of the alternative of exit through sale. See Barnard, *supra* note 165, at 1151-52; Gilson & Kraakman, Institutional Agenda, *supra* note 32, at 866-67. The problem with this incentive story is that it neither accounts for the behavior differential between the public and private sectors nor recognizes that inactivity might nevertheless be a more rational alternative from the point of view of a particular private sector agent.

²⁰⁷ See *supra* text accompanying notes 151-52.

²⁰⁸ If the career patterns of the most prominent actors are any guide, job shifts over to the private sector also seem to be a possible reward.

²⁰⁹ A second type of political entrepreneur also has appeared. This is a professional intermediary who makes the good governance case to management from an inside position. The intermediary argues that voluntary acceptance of a program of internal monitoring procedures minimizes the possibility of becoming an institutional target. Two prominent lawyers, Martin Lipton and Ira Milstein, take the prominent roles in this capacity. See Martin Lipton & Jay W. Lorsch, A Modest Proposal for Improved Corporate Governance, 48 BUS. LAW. 59, 67-75 (1992) (recommending the separation of the chief executive and board chairman functions, longer and more frequent board meetings, smaller boards, use of outside consultants, periodic evaluation of the C.E.O.'s performance, and an annual

4.10.2.4 *Credibility and Possibilities for Capture*

A number of factors make public pension fund agents suitable for this 'public-regarding' entrepreneurship. The credibility of a shareholder who proposes a cooperative engagement with management is enhanced by a concrete commitment to a long-term investment in the firm. The public agents' indexed portfolios give them a long-term posture as a structural proposition. Their interventions, accordingly, hold out no possibility of a hidden defection strategy keyed to exploiting the management vulnerability that follows from public targeting.²¹⁰ Nor, given indexing and the multiplicity of institutional holders, is it likely that a proponent or group of proponents could use voting power or the opportunity of access to management to defect from the wider shareholder interest in exchange for rents from the target. A particular pension fund agent has reputational concerns that limit such a possibility to an end period.²¹¹ The agent's ability to exercise a reputational threat against management depends ultimately on the agent's ability to rally votes from the wider institutional community.²¹² Since votes against management remain the exception rather than the rule, the proponent must husband its reputation to continue to play, selecting targets carefully and representing the interests of the entire group of shareholders in the engagement with management. Informational slack seems unlikely to open up any room for self-seeking maneuvers. The institutions operate in an informal network, and the managers themselves remain ready to publicize any misconduct.²¹³ In short, guardianship here is easily contested.

meeting with the company's largest shareholders); see also Jay W. Lorsch, Empowering the Board, HARV. BUS. REV. 107 (Jan.-Feb. 1995) (describing activist board strategies).

The General Motors Board adopted a set of 'guidelines' in 1994, drafted by Milstein. These provide for annual evaluation of the C.E.O. but little else. See The GM Board Guidelines, DIRECTORS & BOARDS, Summer 1994, at 5.

²¹⁰ Conflicts over short term gain and long term strategy are entailed in these engagements. These conflicts are discussed publicly, particularly where the issue is the unbundling of a conglomerate.

²¹¹ That is, when termination of a particular relationship is contemplated. Presumably, an end period results only when a given agent has decided to leave the field of money management. Cf Black, Agents, supra note 30, at 851 (observing that shareholder engagement is a repeated game, retaliation against cheaters can be expected, and money managers will rarely be in an end period with respect to one another).

²¹² Romano conducted a comparative survey of the voting policies of public and private funds and found no statistically significant differences in voting patterns on process and structure issues, and a common pattern on most social issues. Romano, Pension Fund Activism, supra note 182, at 831-39.

²¹³ See Black, Agents, supra note 30, at 817.

Competing demands on, and the possible capture of, agents of public pension funds can more plausibly be hypothesized from a different direction. The bureaucratic positions of public pension fund agents make them vulnerable to pressure from constituency interests frequently opposed to shareholder interests. Management is one of those constituencies. These actors are, after all, agents of the same governments that managers already have captured, at least within the production of corporate law. Accordingly, political contestability makes it imprudent to predict that this form of entrepreneurship will remain vital indefinitely.

Roberta Romano has suggested that state-based concerns, such as political pressure to support local firms and engage in other forms of locally directed social investing, could limit the freedom of action of pension fund agents.²¹⁴ Certainly a close tie between a state and a particular firm would create a conflict for that fund agent. As Romano also suggested, however, these conflicting demand situations are geographically specific rather than systemic. They therefore differ from the more general threat of management pressure that still controls private actors. Given a multiplicity of players, the conflicts can be worked out within the network: The agent disabled by the dual demand employs the professional's device of refusal, and the other agents go forward. Romano points to a more systemic threat to the leadership of the public pension funds when she recounts pro-management political maneuvers to place pension fund control in the governors' offices in New York and California.²¹⁵ These maneuvers did not succeed, but they underscore the important point that managers know how to organize themselves and make state governments responsive to their wider agenda. Increased fund activism, predicts Romano, will cause a concomitant increase in political pressure on the funds' governance decisions.²¹⁶

It is hard to gauge the likelihood and prospects of a management political initiative to break the pattern of public fund leadership. Such a campaign would face several barriers. Here, unlike charter competition, the employee beneficiaries provide a countervailing interest. In addition, the funds with the most active postures come from states, such as California, New York, and Wisconsin, with long-standing antimanagerial political traditions.²¹⁷ Finally,

²¹⁴ Romano, *Pension Fund Activism*, *supra* note 182, at 814-20.

²¹⁵ *Id.* The governors presumably also had an interest in controlling the funds to be able to draw on them in closing budget deficits. See Garten, *supra* note 159, at 639.

²¹⁶ Romano, *Pension Fund Activism*, *supra* note 182, at 852. She concludes that pension fund activities cannot replace an active control market as a disciplining force. *Id.*

²¹⁷ CalPERS enlisted the press in fighting off the attack against it, charging that the state was attempting to silence the funds' attacks on management. See Garten, *supra* note 159, at 639.

an initiative would have to succeed on a multistate basis. On the other hand, since the number of key states is small, it would be possible to knock out the core players that provide essential resources to the network with an initiative pointed to the leading jurisdictions. The likelihood of such an attack would increase if takeovers returned as an issue in a political posture replicating that of the 1980s.

4.11 Relational Modes of Shareholder Participation

4.11.1 Institutional Coalitions and Board Membership

Discrete engagements led by public pension funds only begin to realize the benefits projected by the proponents of shareholder participation. More significant results would follow if the institutions formed coalitions and engaged with management to influence the selection of board candidates, or, if necessary, proposed and elected their own minority slates. This strategy's objective is not the acquisition of board control, but the placement of clusters of monitors whose reputational interests are tied to meeting the demands of the shareholder interest. These inside shareholder representatives would work to include performance incentives in compensation schemes, develop additional sources of information and analysis, bring heterogeneity of opinion to board deliberations, watch the managers closely, and, in cases of persistent failure, build boardroom coalitions to replace the managers.²¹⁸

This strategy could be implemented in either of two ways. First, the institutions could voluntarily subscribe to a clearing house that would select candidates and solicit proxies for them.²¹⁹ Second, the concentration of institu-

²¹⁸ See Gordon, *Cumulative Voting*, *supra* note 148, at 133-12. Gordon does not think that these institutional monitors should be selected with a view to competing with management in the creation of investment and management policy. The hypothesized monitors do not possess company specific expertise; aggressive intervention for structural changes like downsizing could lead to adverse political consequences. *Id.* at 13442; see also Barnard, *supra* note 165, at 1165-68 (explaining that institutional investors and shareholders lack necessary expertise to play an effective role in corporate governance); Gilson & Kraakman, *Institutional Agenda*, *supra* note 32, at 880 (arguing that since institutional investors lack the expertise for monitoring management, they must delegate this function to outside directors).

²¹⁹ Gilson and Kraakman propose an institutional clearinghouse that would develop a pool of candidates. See Gilson & Kraakman, *Institutional Agenda*, *supra* note 32, at 883-88. The amendment of the proxy rules permitting shareholders to split their votes between the management slate and an opposing slate, see *supra* note 180, facilitates this strategy by making it possible to run a slate for a small number of seats.

tional holdings could increase to a level that would make the formation of informal institutional voting coalitions more feasible.²²⁰ Unfortunately, no movement toward the realization of either strategy seems to exist in practice. No volunteers have come forward to organize a governance association, nor have the proportionate holdings of individual institutions risen to a point that small subgroups have a stronger voting influence.²²¹ The present disposition of institutional incentives heralds no change. All the cost and reputational disincentives that leave the public institutions in a secondary role in discrete engagements also deter special investment in monitoring. Additional disincentives deter the taking of larger positions: Institutions continue to value liquidity,²²² and performance pressures deter risky long-term commitments.²²³ The same financial concerns deter the extension of public pension fund entrepreneurship to the board membership politics. Given the nonspecific, long-term financial gains of effective monitoring, the disincentives make it unlikely that institutions will invest in board election campaigns in the foreseeable future.

4.11.2 Monitoring by Block Holders

Recognition of the difficulties with the coalition strategy has led proponents of shareholder participation to reconsider the possibilities of an historically

²²⁰ An intermediate strategy, the permanent shareholder advisory committee, has not met with enthusiasm from either the commentators, see Barnard, *supra* note 165, at 1 165-68; Gilson & Kraakman, *Institutional Agenda*, *supra* note 32, at 871-72, or the shareholders themselves. A proposal for an advisory committee made by Mr. Robert Monks at Exxon received only 8% of the vote. See Charles F. Richards, Jr. & Anne C. Foster, *Exxon Revisited: The SEC Allows Pennzoil to Exclude Both Mandatory and Precatory Proposals Seeking to Create a Shareholder Advisory Committee*, 48 BUS. LAW. 1509, 1511 (1993).

²²¹ The top 20 institutions hold 21 % of American equities, and concentration falls off thereafter. See Coffee, *Half-Time Report*, *supra* note 32, at 852. The holders of the 21% hold sole voting authority as to only three-quarters of their blocks. *Id.* at 854. Furthermore, the number of mutual funds continues to increase. *Id.* at 855.

A helpful contrast may be Britain, where the largest 25 institutions hold an absolute majority of the shares. *Id.* at 854. A somewhat more active pattern of shareholder participation follows from the higher level of concentration. In the case of a seriously underperforming company, the four or five largest institutional holders of British firms consult informally. The largest holder takes the organizing lead and takes the group's concerns to the managers in the case of poor performance. See Bernard S. Black & John C. Coffee, Jr., *Hail Britannia?: Institutional Investor Behavior Under Limited Regulation*, 92 MICH. L. REV. 2046-53 (1994).

²²² Coffee, *Half-Time Report*, *supra* note 32, at 851.

²²³ See *id.* at 867.

tested mode of relational investing, large block ownership.²²⁴ The model block owner is the legendary Warren Buffett, a fundamental value investor who takes large, underdiversified, long-term positions; monitors carefully; but does not attempt to interfere with the formulation or implementation of the business-plan, except in a crisis.²²⁵ This model actor's large equity investment plainly provides an incentive for active monitoring. It is less clear, however, whether there are any incentives that might induce existing investment institutions to make these large block investments. Relational investors of this type appear only rarely in American capitalism.²²⁶ When they do, they are either individual entrepreneurs; specialized, privately held venture capital firms; or other large corporations.²²⁷ Gilson and Kraakman, drawing on the venture capital model and a Swedish precedent, suggested a vehicle for expanding the set of these players. They proposed that closed-end investment companies be formed to take ten to thirty-five percent positions in a number of salvageable companies. These firms would monitor actively and hold for long periods but eventually would turn over their positions to cash in on the gains of effective influence.²²⁸ This proposal arouses standard institutional skepticism about the projected financial returns: Absent any firm-specific expertise on the part of the investor, competitive gains seem unlikely as a systematic proposition.²²⁹

4.11.3 Credibility and Possibilities for Capture

Possibilities of capture and defection raise questions about block ownership's ordinary course suitability as a mode of shareholder participation. Coalition-based board voting, in contrast, suggests neither problem.

²²⁴ Black cites studies showing a positive relationship between Tobin's Q (the ratio of asset replacement value and market value of equity) and the size of ownership blocks where the blocks are between 5% and 20%. Bernard S. Black, *The Value of Institutional Investor Monitoring: The Empirical Evidence*, 39 *UCLA L. Rev.* 815, 918 (1992).

²²⁵ See Gordon, *Cumulative Voting*, *supra* note 148, at 129-30. Note that the monitoring strategy duplicates that envisioned with coalition-based board voting.

²²⁶ See Louis Lowenstein, *Opening Remarks*, Columbia University Institutional Investor Project Conference on Relational Investing New York, N.Y., May 6, 1993: 'More Like Whom?', 18 *J. CORP. L.* 697, 704 (1993).

²²⁷ For examples, see Rock, *Dark Side*, *supra* note 161, at 990-99.

²²⁸ See Gilson & Kraakman, *Investment Companies*, *supra* note 149, at 995-96. They hope for a 50% increase in the stock price over the holding period. The closed-end form is necessary to secure a long-term commitment; the gain must, of course, be net of the closed-end discount. *Id.* at 1005-06.

²²⁹ See Pozen, *supra* note 186, at 148.

With coalition-based board voting, as with public pension fund activism, the combination of cross-monitoring, reputational interests, and contestability of guardianship provides a circumstantial guarantee that participants will remain faithful to the shareholder interest.²³⁰ Yet circumstantial guarantees of fidelity to the relational ideal of patience and cooperation are less clear cut. It seems unlikely that members of such coalitions could, or would, bond themselves to long-term cooperation by committing, implicitly or explicitly, to reject a tender offer. Their legal duties and reputational interests lie in value maximization for beneficiaries, with no fine distinctions being made about short or long-term means to the end. Even with an implicit commitment to the firm and institutional internalization of a norm of patience, the incentive to defect from the coalition and accept an attractive tender offer would be powerful.²³¹

This element of short- versus long-term instability does not completely undercut the cooperative possibilities of the board voting strategy, however. The coalition, by hypothesis, has the votes to insert its monitors whether or not management consents in advance. Thereafter, the structural possibility of a hostile attack gives management an incentive to cooperate to the extent that doing so decreases the likelihood of attack.

The block-owning monitor has a similar incentive to abandon management when faced with a tender offer, but the monitor is also more susceptible to capture by management. In this situation, management can compete with the offeror by offering the holder a side deal, exchanging additional returns on invested capital for a binding commitment not to tender.²³² The holders' substantial equity commitment creates an incentive to defect to the management side, and at the same time it undercuts any reputational concerns about serving the wider shareholder interest. Given financial rather than political

²³⁰ See Black, *Agents*, *supra* note 30, at 817, 851, 855; Gordon, *Cumulative Voting*, *supra* note 148, at 171.

²³¹ Lowenstein reports that during the 1980s major British funds responded to tender offers by holding collegial inquiries into the integrity and efficiency of target managers, and, in fact, rejected a few tender offers as a result. American fund managers, pressed by competition and fiduciary duty, always tendered. Lowenstein, *supra* note 182, at 10-11.

Another possible route of defection should be mentioned. The holder can threaten a tender offer himself, as Mr. Kirk Kerkorian recently did with Chrysler. See Steven Lipin & Dave Kanas, *Offer for Chrysler May Signal Return of the Corporate Raider*, *WALL ST. J.*, April 13, 1995, at C1.

²³² In the standard deal, the block holder receives preferred stock in exchange for a standstill, or gives management a call option. Indirect payments can come from investment banking fees, other product contracts, or access to inside information. Rock, *Dark Side*, *supra* note 161, at 1004-06.

entrepreneurship, the incentives would appear to lie in the Opposite direction.

In the proponents' story, the block owner charts a course between these alternative defections. It makes an implicit commitment to management to reject an offer that lacks a basis in fundamental value analysis.²³³ Thereafter, it plays a tit-for-tat cooperative game, holding to its commitment to the extent management performs, but standing ready to defect to an outside offeror if management fails to deliver.²³⁴ Meanwhile, a successful cooperative relationship makes a hostile offer unlikely. Since the block owner plays this cooperative game with multiple firms as a going business, it develops a reputational interest for exercising its judgment in a discriminating way when faced with a tender offer.²³⁵ It becomes a gatekeeper for good and bad tender offers.

The problem with this story lies in the complicated mix of elements that figure into economic accounts of the sources of merger gain. Tender offer premiums of the 1980s had multiple sources. Under Kraakman's 'joint gains' explanation, the offeror pays a premium to make up a discount between the equity's market value and the intrinsic value of the going concern. Given a competitive market, the offeror must make up the discount. Its profit comes after the acquisition, from either (or a combination of) synergistic gains, better management, or the resale of parts of the target in the market for going concern assets.²³⁶ Let us assume that all tender offers correctly are typed as motivated by the pursuit of gains through one of the three strategies, and consider the position of the block holding gatekeeper as to each.

The tender offer motivated by synergistic possibilities does not seem well suited to the block holder's business judgment, absent particular expertise in the given production function. This leads the block holder to a difficult reputational choice: Its relational monitoring role, narrowly defined, does not require

²³³ See Ayres & Cramton, *supra* note 19, at 1041.

²³⁴ Cf Ayres & Braithwaite, *supra* note 13, at 26-38 (hypothesizing a tit-for-tat cooperative game between government agency and regulated firm).

²³⁵ Ayres & Cramton, *supra* note 19, at 1060-61; cf Gilson & Kraakman, *Investment Companies*, *supra* note 149, at 1005 (concluding that the block investor that becomes too activist loses friendly access and cannot sustain the business).

²³⁶ See Reinier Kraakman, *Taking Discounts Seriously: The Implications of 'Discounted' Share Prices as an Acquisition Motive*, 88 COLUM. L. REV. 891, 925-30 (1988). Kraakman followed financial economic theory in accounting for the discounts, attributing them to either management misinvestment of free cash flows or systematic imperfections in market pricing. *Id.* at 907-11. Other commentators abandon the limiting assumptions of finance theory and cite downward-sloping demand in stock market pricing.

See Richard A. Booth, *Discounts and Other Mysteries of Corporate Finance*, 79 CAL. L. REV. 1053, 1095-97 (1991); Lynn A. Stout, *Are Takeover Premiums Really Premiums? Market Price, Fair Value, and Corporate Law*, 99 YALE L.J. 1235, 1259-75 (1990).

it to forego a share of the synergy motivated premium. Unfortunately, management might view a commitment to patience and cooperation more broadly. A side payment in exchange for refusal to tender would provide a neat resolution of the holder's conflict, so long as the holders' reputational interest lies more with cooperation with managers rather than with a public regarding appearance in the wider institutional community.²³⁷

The block holder's gatekeeper role would seem better suited to tender offers motivated by gain through better management or resale of going concern assets. In this case, the holder's superior information about company practices enables it to appraise prospects for management improvement; chances for gain through dismemberment presumably will have been explored in the course of the relationship. Even here, the holder's loyalty to the cooperative strategy will be tested if, as Kraakman asserts, most of the premium comes from the making up of the discount.²³⁸ If we open up the valuation theory to admit a likelihood of overbidding by the offeror,²³⁹ the conflict becomes even more severe. The overbidding offeror leaves the block holder with a choice between (a) cooperation and a payoff through speculative governance gains that cannot, in any event, make up the discount between intrinsic value and the market price of the stock, and (b) a single-shot payoff that not only makes up the discount but, given overbidding, clearly offers a greater return than that held out by patient monitoring. Even given a reputational interest in integrity in the gatekeeper role, the blockholder's temptation to defect and take end period gains would be strong, particularly if a trend of stepped-up tender offer activity held out possibilities of short-term gain in similar investment positions. This scenario invites a restatement of the two choices above: (1) defect, abandon cooperation, and go into an end period;²⁴⁰ or (2) adhere to the cooperative commitment and take a side payment.²⁴¹

²³⁷ We note that hopes for synergistic gains and other management-driven objectives figure prominently in the recent revival of merger and acquisition activity. A few transactions have entailed hostile bids, but most have been friendly. See Randall Smith & Greg Steinmetz, *Mergers Surge as Firms Find a Rising Economy and Cheap Financing*, WALL ST. J., Mar. 16, 1994, at al; *Mergers in America: Something in the Waves*, *The Economist*, Nov. 16, 1993, at 89.

²³⁸ Kraakman, *supra* note 235, at 925-27.

²³⁹ Kraakman discounts this possibility. *Id.* at 893-905. Others take the opposite view.

See Bernard S. Black, *Bidder Overpayment in Takeovers*, 41 STAN. L. REV. 597, 61-15 (1989).

²⁴⁰ The mid-1980s experience of bondholders holding portfolios of covenantless paper in reliance on management's reputational interest in capital market access provides a good example of this risk.

²⁴¹ Ayres & Cramton, *supra* note 19, at 1059-61, recognize these problems in suggesting

4.12 Summary

The foregoing discussion of capture risk respecting block holders dovetails with the discussion of capture risk respecting agents of public pension funds: The availability or effectiveness of either mode of participation may be limited by historical contingencies, with the likelihood of hostile takeover activity being a salient one. It is hardly a coincidence that relational investing models found their way into circulation after the lapse of hostile takeover activity in 1989. The disappearance of the market deterrent both ensured an absence of countervailing interest group demands that might have impaired the public pension funds' freedom to take a leadership role in discrete participation and made plausible the projections of long-term cooperative participation by private institutions. The new cycle of acquisition activity that commenced in 1993 could, but need not, materially change this favorable climate.²⁴² Another salient contingency is the relative level of concentration of institutional equity holdings. Absent a marked increase of concentration in the industry, we may not see the emergence of circumstances conducive to the appearance of coalition-based relational participation.

IV. FEDERALLY MANDATED SHAREHOLDER INITIATIVE

The law reform agenda surrounding the institutional investor movement tends to look in the federal direction. This is partly because the proxy process is heavily federally regulated. Reform initiatives already have prompted the SEC to remove barriers to shareholder initiative.²⁴³ However, the reformers would like to see additional changes that would shift more of the costs of shareholder initiatives from the proponents to the firms. The primary agenda item here is mandatory inclusion of shareholder board nominees in the firm's proxy statement.²⁴⁴

that relational investing might help to forestall bad tender offers. We are less sanguine than they about the possibility that the problems can be resolved for the benefit of the shareholders as a group.

²⁴² So far, the new cycle is management-driven and friendly in most cases; see sources cited *supra* note 236, indicating no significant change.

²⁴³ See *supra* note 180.

²⁴⁴ Without such a reform, the proponent must invest in its own proxy solicitation, a prohibitively expensive process absent a control acquisition objective. For a recent suggestion that this reform be undertaken by SEC rulemaking, see Coffee, *Half-Time Report*, *supra* note 32, at 900-02. Coffee argued that multiple slates are unlikely, given the instability of institutional voting coalitions, and noted that a minimum support threshold could be

A broader federal law reform agenda also follows from the financial theory of shareholder participation. This asserts that present levels of institutional concentration could give rise to financial incentives sufficient to induce subgroup formation if the federal government removed ancillary legal constraints that increase the costs and risks of collective action.²⁴⁵ We have no basis for controverting this prediction, but, looking to the counter story and the practice, we note a substantial possibility that the present economic structure of the industry may, by itself, deter the appearance of the requisite financial incentives. In the latter event, institutional shareholder participation can be expected to persist only in a discrete form, with reputational incentives figuring in significantly as inducements. The possibility that the future framework for action will be thus limited implies expansion for the law reform agenda-to

imposed to deter overutilization. He also suggested that access be opened for proposals counter to management proposals. *Id.*

Access proposals such as this have a long history. See, e.g., Securities and Exchange Commission Proxy Rules, Hearings Before House Comm. on Interstate and Foreign Commerce on H.R. 1493, H.R. 1821 & H.R. 2019, 78th Cong., 1st Sess. 17-19, 34A3 (1943) (proposal for shareholder nomination in issuer proxy statement); Proposed Tender Offer Reform Act of 1987, H.R. 2172, 100th Cong., 1st Sess., § 6 (1987) (holders of 3% or \$500,000 worth of equity to have right to include own proxy materials and board candidates); see also EISENBERG, *supra* note 14, at 117-21 (proposing that shareholders holding 5% have the power to nominate directors in proxy statement); Louis Lowenstein, *What's Wrong with Wall Street: Short-Term Gain and the Absentee Shareholder* 209-11 (1988) (proposing that shareholders have right to nominate one-fifth to one-fourth of entire board); George W. Dent, Jr., *Toward Unifying Ownership and Control in the Public Corporation*, 1989 WIS. L. REV. 881, 907-08 (proposing that a committee of 10 or 20 largest holders have exclusive access to proxy machinery).

'Access' implies cost shifting. Cost shifting, however, could be directed without access, on the assumption that the subsidized proponent proceeds with its own solicitation. Bebchuk and Kahan recommend compensation for challengers both in board voting contests and issue contests, with compensation for both board incumbents and challengers made contingent on receipt of a threshold percentage of votes, and more generous compensation for challengers in issue contests. See Bebchuk & Kahan, *supra* note 96, at 1077.

²⁴⁵ The targets are: (1) disclosure requirements imposed on holders of more than 5% of a class of securities under section 13(d) of the Williams Act, 15 U.S.C. § 78m(d) (1988); (2) liability of controlling persons for securities law violations of controlled persons under section 15 of the Securities Act, 15 U.S.C. § 770 (1988), and section 20(a) of the Exchange Act, 15 U.S.C. § 78t (1988); (3) short-swing liability for trading profits of 10% holders under section 16(b) of the Exchange Act, 15 U.S.C. § 78p(b) (1988); (4) restrictions on capital structures and incentive compensation for advisors of investment companies under sections 18(d) and 23 of the Investment Company Act, see 15 U.S.C. §§ 80a-I 8(d), 8-23(a)-b) (1988); and (5) portfolio diversification requirements under ERISA. See Roe, *supra* note 34, at 26-27.

increase the benefits attainable through discrete action in addition to reducing the costs of relational shareholder participation. Toward this end, we present the following case for an incremental levelling of the field that state law provides for shareholder initiative.

We propose a federally mandated privilege of direct shareholder access to amend the corporate charter at the annual meeting of shareholders, with cost-shifting to be effectuated through access to the proxy statement for the making of proposals.²⁴⁶ We would limit this access privilege to matters of process and structure and exclude most business matters allocated to the board by state codes.²⁴⁷ The boundary dividing process and business would have to be drawn in the preempting legislation.²⁴⁸ In drawing it, we would place contract terms relating to management's incentives on the 'process' side. Thus, whatever the state law status, the federal law would grant access for poison pill redemption and opting out of any state legislation with an opt out provision, in addition to traditional process matters such as the structure and composition of boards and committees. More tentatively, we also propose access for substantive- proposals respecting executive compensation.²⁴⁹ How-

²⁴⁶ There will be ancillary problems respecting the proposal's preemptive reach. States could nullify a narrow access mandate in numerous ways. For example, a code's system of process and structure default rules could be reconstituted as a system of mandates. Or a state could amend the process provision governing charter amendments to differentiate amendments by source and require a supermajority for shareholder initiated proposals. We think that the proposal's inclusion of access for reincorporation decisions provides a circumstantial guarantee against the former possibility. As to the latter possibility, two drafting solutions suggest themselves. The preempting legislation could either provide that a simple majority always suffices or provide that the required percentage for a shareholder initiated proposal be no lower than that provided in respect of a management proposal. The latter, less intrusive, approach should suffice, on the assumption that no state would respond by amending its code to require supermajorities across the board.

²⁴⁷ See DEL. CODE ANN. tit. 8, § 141(a) (1991) (requiring business of corporation to be managed by or under direction of board).

²⁴⁸ State law draws a working but vague subject matter line between board authority and shareholder authority that accords the shareholders a privilege of initiative respecting by-laws, to the extent consistent with the charter and state law. See DEL. CODE ANN. tit. 8, § 109 (1991). Given the statutory allocation of power over business decisions to the board, see DEL. CODE ANN. tit. 8, § 141(a) (1991), the scheme implies a distinction between business decisions and contract terms respecting process. However, the precise course of this implicit boundary has never been defined. The problem is compounded by the state codes' designation, see *id.*, of default status to the allocation of business decision-making authority to the board-the allocation may be constrained or redirected by charter amendment. As a result, an open-ended mandate of shareholder initiative would hold out the possibility of shareholder direction of all business matters.

²⁴⁹ These proposals carry a deterrent impact that could give the proponent useful

ever, cognizant of Professor Jeffrey Gordon's appraisal of shareholder initiative, we would exclude access to formulation of the business plan, in particular matters of investment and disinvestment.²⁵⁰ Gordon has warned that shareholder initiatives could have two perverse effects. First, given diverse preferences, shareholder access could lead to economic losses due to inconsistent choices; second, access could be manipulated by shareholders pursuing private gain.²⁵¹ We argue that our proposed boundary minimizes these problems.²⁵² Any problems of confusion (or inconsistency) resulting from multiple proposals can be avoided with simple process rules and a share ownership qualification. The latter should be low enough to permit a small number of players in the activist network to qualify a proposal and high enough to exclude the gadflies.

On the technical point as to whether this proposal requires new congressional legislation or could be promulgated as a rule by the SEC, we look to legislation as a practical matter. The legislative history of section 14(a) of the Exchange Act provides a basis for a strong argument that the SEC does have the authority to impose shareholder initiative on the states by rule.²⁵³ That

maneuvering room in the right case. See *infra* note 298. Yet they also create special risks of abuse. The very maneuvering room they could create increases the risk that a proponent might exchange the withdrawal of the proposal for private rents. In addition, substantive compensation proposals would be particularly attractive to actors with political agendas unrelated to shareholder value. Such a hostile, politically motivated proposal, if directed to an extraordinarily well compensated but effective manager, could destabilize a valuable working relationship; that deleterious effect need not depend on a high probability of passage.

We put this component of our proposal on the table for discussion based on an appraisal that a big stick, placed in the hands of serious proponents, has a value that outweighs the risks. Shareholders are habitually suspicious of both politically motivated proposals and intervention against board business judgments; serious proponents, accordingly, would employ this big stick only in extraordinary situations.

²⁵⁰ The combination of a green light for poison pill redemptions, compensation matters, and opting out and a red light for other business matters could not be achieved as a drafting proposition simply by excluding from access any amendment that removes authority delegated to the board under the state code's general delegation. The permitted subjects would have to be specified. One candidate for specific exclusion would be the corporate purpose section of the charter. An amendment of the charter to exclude a line of business presently conducted by a firm would make all of its contracts *ultra vires*, presumably necessitating the sale of the line of business.

²⁵¹ See Gordon, *Shareholder Initiative*, *supra* note 29, at 361.

²⁵² See *infra* notes 310-27 and accompanying text.

²⁵³ See Fisch, *supra* note 162, at 1170-74 (marshalling the legislative history in arguing for shareholder access by rule); Patrick J. Ryan, *Rule 14a-8, Institutional Shareholder Proposals, and Corporate Democracy*, 23 GA. L. REV. 97, 146 (1988) (conducting a

result depends, however, on the theory of statutory interpretation the observer brings to bear,²⁵⁴ and a recent, notably restrictive judicial ruling²⁵⁵ of section 14(a) has left the SEC with cause to be reluctant to experiment with new rules.²⁵⁶ This uncertainty leaves us expecting that any significant alteration of the federal-state balance regarding shareholder voting will come through legislation.²⁵⁷

legislative history of § 14 and concluding that Congress supported 'strong and active shareholder participation in corporate enterprise within the general framework of management-shareholder relations established by the general common and statutory law'). For other expansive interpretations, see Louis Loss, *Fundamentals of Securities Regulation* 453 (2d ed. 1988); Roberta S. Karmel, Qualitative Standards for 'Qualified Securities': SEC Regulation of Voting Rights, 36 CATH. U. L. REV. 809, 824 (1987).

²⁵⁴ For a different reading, see Stephen M. Bainbridge, Redirecting State Takeover Laws at Proxy Contests, 1992 WIS. L. REV. 1071, 1112. Bainbridge read the legislative history to limit § 14(a) to matters of disclosure and leave substantive voting rights unaffected. See also Robert C. Clark, *Corporate Law* 366 (1986) (noting that § 14(a) concerns disclosure and process and does not preempt or add to state law on existence, distribution, or content of voting power).

²⁵⁵ Compare SEC v. Transamerica Corp., 163 F.2d 511, 517-18 (3d Cir. 1947) (holding that a corporation could not apply a by-law in such a way as to block a shareholder by-law amendment proposal and implying a federally guaranteed right of access, albeit vaguely), cert. denied, 382 U.S. 847 (1948) with Business Roundtable v. SEC, 905 F.2d 406, 411-15 (D.C. Cir. 1990) (invalidating the 'one share, one vote' provision in Rule 19c-4, placing a limited reading on § 14(a), and distinguishing between procedural and disclosure regulations that facilitate rights to vote granted by state law, deemed to be within § 14(a), and SEC determinations as to when a vote is required, deemed to be outside the scope of the rule).

²⁵⁶ Cf Coffee, Half-Time Report, supra note 32, at 876 (noting that the SEC vacillates on the role of institutional investors).

²⁵⁷ We note that part of what our proposal seeks to achieve could be achieved by rule on a relatively secure statutory basis. Specifically, the SEC could (and we think should) amend rule 14a-8 to include by-law amendments.

In any event, we would recommend that any bill be drafted with specificity to reduce the chance of & post nullification in administrative proceedings. One grey area would of necessity have to be left for case by case determination by the SEC. No complete, self-executing definition of 'process and structure' could be drafted as a practical matter. While a concrete list of subject matter can be culled from the existing institutional agenda and the state codes, novel proposals would occur over time, necessitating reliance on agency administration.

4.13 Management Agenda Control and State Corporate Codes

4.13.1 Description of the System

Political theory tells us that legislative outcomes in electoral democracies depend on the collective choice rule utilized by the legislature—different process rules lead to different outcomes given the same set of electoral preferences.²⁵⁸ It follows that the actor who sets the agenda can control the outcome, and that a particular process institution's constraints on agenda formation have systematic implications for outcomes.²⁵⁹

The agenda-setting procedures for shareholder voting in public corporations have easily-described outcome implications. Control of the proxy machinery gives management working control over the mandatory shareholder board vote.²⁶⁰ Shareholder votes also are mandated for fundamental changes charter amendments, dissolution, certain mergers, and significant asset sales. Under the process rules of most state codes,²⁶¹ however, these matters may not be put before the shareholders until the board first approves a resolution.²⁶² The condition of board approval amounts to a management vet-to control the agenda one must control the board. The shareholders have a veto in turn, but no access to the agenda. This absolute control²⁶³ over the corporation's contractual agenda is subject to two exceptions. One is the section 14(a) precatory shareholder proposal, pursuant to which a shareholder who meets suitability requirements can set an agenda item, but only for a nonbinding vote.²⁶⁴ The

²⁵⁸ See William K. Riker, *Liberalism against Populism: a Confrontation between the Theory of Democracy and the Theory of Social Choice* 37 (1982).

²⁵⁹ See Kenneth A. Shepsle & Barry R. Weingast, Uncovered Sets and Sophisticated Voting Outcomes with Implications for Agenda Institutions, 28 AM. J. POL. SCI. 48, 67 (1985).

²⁶⁰ As the foregoing discussion of barriers to shareholder voting coalitions implies, management's practical control is vulnerable only to a challenger willing to invest in a takeover or full-blown proxy contest.

²⁶¹ For a survey, see *infra* notes 281-83 and accompanying text.

²⁶² See DEL. CODE ANN., tit. 8, §§ 242(b)(1) (charter amendments), 251 (b)-(c) (mergers), 271(a) (sales of substantially all assets), 275(a) (dissolution) (1991).

²⁶³ Management's process advantage in the event of a challenge, whether by proxy fight or shareholder proposal, also remains substantial. It has wide discretion to invest corporate funds on the defensive side, and with the help of proxy solicitors, maintains a substantial informational advantage. See Black, Agents, *supra* note 30, at 825-26; Black, Shareholder Passivity, *supra* note 155, at 593-94. Despite amendments to the rules under § 14, management still has some room to manipulate shareholder preferences by bundling proposals. See *supra* note 180.

²⁶⁴ See *supra* note 162. There is an exception to the rule of nonbindingness for proposals

other is a state law shareholder access privilege respecting by-law amendments,²⁶⁵ the utility of which is limited. By-laws may contain any provision relating to the business or its conduct, not inconsistent With the rest of state law or the charter.²⁶⁶ This means that coverage of subject matter in the charter preempts contrary treatment in the by-laws, opening possibilities for strategic tiering of provisions. Management-protective exploitation of this possibility is a basic corporate lawyering skill, extensively put to use in the drafting of the antitakeover charter provisions of the 1980s. Some of the items from the checklist of shark repellent provisions, such as poison pills²⁶⁷ and provisions barring shareholder action without a meeting,²⁶⁸ had to be placed in the charter as a matter of statutory mandate. Others, such as staggered boards²⁶⁹ and super-majority voting requirements,²⁷⁰ might be in the charter or by-laws at the firm's option. Management chose the charter, blocking amendment or repeal at the instance of a shareholder challenger not yet in control Of the board but holding a majority of the stock or a majority of the proxies.²⁷¹ Meanwhile, shareholder preferences respecting such provisions underwent a change between the early and late 1980s-defensive charter amendments were routinely ratified during the early period and resisted later on.²⁷² However, the resistance came too late. Defensive charter provisions were widespread by the end of the decade. The new shareholder activists can beg for their removal under Rule 14a-8, but, given the board veto on access to the charter, cannot compel it.

The charter preempts the by-laws only to the extent that it actually covers the subject matter in question. Technical possibilities for shareholder-initiated

for new by-laws. See *infra* note 274.

²⁶⁵ See DEL. CODE ANN. tit. 8, § 109(a) (1991).

²⁶⁶ See *id.* § 109(b).

²⁶⁷ See *id.* § 151(a) (providing that preferred stock contract terms go into the charter; charter can provide in advance for 'blank check' delegation to management of power to authorize preferred stock and fill in terms).

²⁶⁸ See *id.* § 228(a).

²⁶⁹ See *id.* § 141(d), (k) (charter, initial by-law, or shareholder by-law; staggered board has effect of barring action for removal of directors without cause).

²⁷⁰ See *id.* § 216.

²⁷¹ At some point, procedural maneuvering by management to frustrate exercise of the shareholder franchise violates a norm of Delaware law. That point is extreme. Compare *Stahl v. Apple Bancorp, Inc.*, 579 A.2d 1115, 1121-22 (Del. Ch. 1990) (holding that board action frustrating exercise of shareholder franchise requires a compelling justification) with *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651, 662-63 (Del. Ch. 1988) (retreating from requirement of a compelling justification for such board action).

²⁷² See *supra* note 171 and accompanying text.

contracting arise as a result. The charters of public corporations, contrary to the vision of the contractual theorists, did not contain many contract terms before the proliferation of antitakeover provisions. The historic public corporation charter was kept spare to provide management with maximum freedom of action in formulating process rules.²⁷³ The charter contained the minimum terms mandated by the code and terms covering any senior equity securities issued by the firm; by-laws contained standardized process provisions; managers relied on state codes to fill in the rest. Firm contracting evolved during the 1980s mostly to load charters with defensive provisions. The shareholder agenda of the 1990s includes new areas of concern, such as compensation schemes, confidential voting, and board and committee structure. As to these, the charter may provide nothing, leaving open a field for shareholder-initiated by-law amendments. Read literally, the suitability rules under Rule 14a-8 permit by-law proposals, making an initiative cost-effective.²⁷⁴ Some by-law initiatives have gone forward under Rule 14a-8, but, unfortunately, this federal route to contractual access has not proved useful to proponents. Technical questions of federal-state synchronization have arisen as the SEC has dealt with management objections to by-law proposals. State law provides little guidance on these questions, and, at least up to now, management effectively has blown doctrinal dust into the eyes of the SEC.²⁷⁵

²⁷³ This is because charter amendments must be ratified by the shareholders, while by-laws may be promulgated by the board. In an environment in which shareholder initiatives respecting contract terms were rare events, it made cost sense to leave the contracting to the board.

²⁷⁴ See Rule 14a-8(c)(1), which excludes matters that are not a proper subject for shareholder action under state law.

²⁷⁵ The suitability rules are built on three principles. First, the subject matter must be proper under state law under Rule 14a-8(c)(1). Second, the subject matter must not traverse a long list of specific exclusions devised by the SEC over the years. See Rule 14a-8(c)(2)-(13). Third, following *Auer v. Dressel*, 118 N.E.2d 590 (N.Y. 1954), a proposal on a subject matter reserved to the discretion of the board under the state law delegation of authority is nevertheless proper if phrased as a request. The three principles do not synchronize well. There are two problems. First, a by-law proper under state law might nevertheless traverse the SEC list of unsuitable topics. Second, state lawmakers have never had occasion to draw a clear line between board management authority and shareholder by-law promulgation authority. As a result, the extent to which a by-law may constrain the board management authority is not clear. Nor is it clear whether the board of directors, which also has power to promulgate by-laws, can subsequently repeal a by-law approved by the shareholders. The no-action letters play out these problems with conflicting results. Compare *Exxon Corp.*, 1992 SEC No-Act. LEXIS 281, at *1 (Feb. 28, 1992) (allowing the shareholder proposal to establish a committee to oversee the board of directors to be excluded) with *Pennwil Company*, 1993 WL 52187 (S.E.C.) at *52- (Feb. 24, 1993).

4.13.2 Explanation of the System

The rule of absolute delegation came into corporate law with the turn-of-the-century shift toward an entity conception of the corporation—a shift that had the incidental effect of affording freedom of action to the managers of new, mass-producing firms.²⁷⁶ Previously, an agency theory of board authority had prevailed and access had been the rule.²⁷⁷ New Jersey, the early leader in the chartering of large firms,²⁷⁸ conditioned amendment on board approval before 1895.²⁷⁹ Delaware followed in its corporations code of 1899,²⁸⁰ a

(original proposal) and Pennzoil Company. 1993 WL 87871 (S.E.C.) at *40-42 (Mar. 22, 1993) (revised proposal) (suggesting that the shareholder proposal that by-laws were to be amended only by shareholders was not proper under state law). For a summary of the Pennzoil correspondence, see Charles F. Richards & Anne C. Foster, *Exxon Revisited: The SEC Allows Pennzoil to Exclude Both Mandatory and Precatory Proposals Seeking to Create a Shareholder Advisory Committee*, 48 BUS. LAW. 1509, 1513-18 (1993). In the former case, the SEC took a no-action position respecting a proposal for a by-law mandating a permanent shareholder advisory committee, even though the proposal required funding for the committee, arguably traversing the state law delegation of authority to management. The SEC retreated from the position in the latter case, which also concerned a by-law proposing a shareholder advisory committee. Upon resubmission of the proposal on a precatory basis, the SEC still sanctioned the proposal's omission because it contained a block against repeal by a subsequent board by-law. This, said the agency, created a question as to state law validity.

The SEC's treatment of the Pennzoil no-action letter is somewhat counterintuitive as a state law proposition. The state codes, read literally, imply that charter terms trump bylaws, and that shareholder by-laws trump board by-laws, but the point is not clear. The SEC's no-action letters thus have a perverse effect. They invite state courts to determine the issue in management's favor should it come up at the state level. Given the charter competition system, the states have every incentive to decide against the shareholders. For further discussion, see Coffee, *Half-Time Report*, *supra* note 32, at 883-89.

²⁷⁶ See William W. Bratton, *The New Economic Theory of the Firm: Critical Perspectives from History*, 41 STAN. L. REV. 1471, 1489 (1989).

²⁷⁷ See Gordon, *Shareholder Initiative*, *supra* note 29, at 349 n.7 (citing Joseph K. Angell & Samuel Ames, *A Treatise on the Law of Private Corporations*, Aggregate §§ 297-99 (9th ed. 1871); 1 Victor Morawetz, *Treatise on the Law of Private Corporations* §§ 243-44 (2d ed. 1886)).

²⁷⁸ New Jersey began to liberalize its code after 1890, with considerable financial success. See Christopher Grandy, *New Jersey and the Fiscal Origins of Modern American Corporation Law* 43A5 (1993).

²⁷⁹ JAMES B. DILL, *The Statutory and Case Law applicable to Private Companies under the General Corporation Act of New Jersey and Corporation Precedents* 42-43 (1899) (reproducing New Jersey General Corporation Act §27).

²⁸⁰ See Act of 1899, 21 Del. Laws ch. 273, § 135.

piece of legislation that manifested its determination to enter into charter competition with neighboring New Jersey.²⁸¹ Access limitation provisions diffused into the codes of other states during the subsequent decades. By 1960, twenty-five state codes conditioned charter amendment on board approval;²⁸² by 1970, twenty-eight state codes did so;²⁸³ by 1993, forty state codes did so.²⁸⁴ Today, only ten state codes leave a door open to shareholder access.

This historical sequence can be read as further confirmation of the capture of state codes by the management interest: It is no accident that this component of management agenda control dates to the first instances of the purchase and sale of corporate codes. Another plausible story has been offered, however. Jeffrey Gordon has set out a functional explanation for absolute delegation, tied to his observations that an open agenda could lead to costly shareholder voting cycles and self-dealing by proponents of initiatives directed to the firm's business.²⁸⁵ The tie led him to a three-part argument that explained the statutory pattern as a result of evolutionary efficiency.²⁸⁶ First, if the absolute delegation rule had a significantly negative effect on value, some states would offer an alternative. Second, although many states do permit corporations to contract around the delegation of business decisionmaking power to the board,²⁸⁷ public corporations have not offered charter terms that take up this option. Third, unlike antitakeover resolutions, which have a negative impact on share prices, the absolute delegation rule has a long historical standing that share prices already reflect. Citing Jensen and Meckling's famous article on agency costs,²⁸⁸ Gordon concluded that if the rule injures shareholders, man-

²⁸¹ See Russell Carpenter Larcom, *The Delaware Corporation* 11-13 (1937).

²⁸² See 2 *Model Business Corp. Act. Ann.* 23-31 (1960).

²⁸³ See 2 *Model Business Corp. Act. Ann. (Second)* 260-61 (1971).

²⁸⁴ See 2 *Model Business Corp. Act. Ann. (Third)* 1172-73 (Supp. 1993). The MBCA count is 38. We disagree as to two omissions: N.Y. BUS. CORP. L. §§ 803, 804 (McKinney 1986), and *Utah Code Ann.* § 16-10a-1003 (Cumulative Supp. 1994). Of the 10 states that omit the board veto, four allow a stated percentage of shareholders to propose amendments (Idaho, Minnesota, North Dakota, and Pennsylvania); five have no process provisions respecting amendment proposals (Louisiana, Massachusetts, Michigan, Ohio and Wisconsin); California, somewhat ambiguously, requires a board resolution before or after the shareholder vote. CAL. CORP. CODE §§ 902, 904 (West 1990).

²⁸⁵ See Gordon, Shareholder Initiative, *supra* note 29, at 35761. For our discussion of the cycling problem, see *infra* notes 313-27 and accompanying text.

²⁸⁶ See Gordon, Shareholder Initiative, *supra* note 29, at 357-59.

²⁸⁷ See, e.g., DEL. CODE ANN. tit. 8, § 141(a) (1991).

²⁸⁸ See Gordon, Shareholder Initiative, *supra* note 29, at 358 (citing Michael C. Jensen & William H. Meckling, Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure, 3 J. FIN. ECON. 305 (1976)).

agers bear the agency costs when they initially sell stock to the public.

In response to the first argument, we note that a number of alternative codes do exist, but we think that inattention by local bar associations and other management representatives is the best explanation for the isolated persistence of shareholder access provisions. Given management agenda control over reincorporation decisions,²⁸⁹ no actively competing jurisdiction would include shareholder access in its product package, even if access were thought to have a positive impact on shareholder value.

We also question the probative value of the second argument's point that public corporations have not exploited opportunities to opt out of the absolute delegation of ordinary business decisionmaking authority to the board. Agenda control follows from process provisions that appear to be mandatory and is analytically distinct from the statutory delegation of business decisionmaking authority.²⁹⁰ Opting out of the board authority delegation came into the codes to facilitate shareholder-level contracting as a means to police opportunism in closely held firms. The charter amendment that makes use of this permission removes decisionmaking authority from the board to the shareholder level. Such a broad-brush removal is neither feasible nor desirable in a publicly held firm. A public corporation conceivably could exploit the permission by expanding the set of transactions that must be submitted for shareholder approval. However, doing so would not open the agenda to shareholder charter amendments; instead, the charter would set the agenda, and management would retain a degree of control over the initiation and timing of the transaction eventually submitted to the shareholders.²⁹¹

²⁸⁹ See *supra* notes 69-72 and accompanying text.

²⁹⁰ See, e.g., *Del Code Ann.* tit. 8, § 242(b)(1) (1991) (charter amendments to be approved by the board). This doctrinal distinction is long standing. See Henry Winthrop Ballantine, *Ballantine on Corporations* § 97, at 320 (1927) (distinguishing between director and stockholder powers).

²⁹¹ We note the possibility that a charter could be amended to remove to the shareholder level the determination of the charter amendment agenda. Certainly this is the inevitable result in closely held firms that move all business decisionmaking to the shareholder level, as the statute permits. However, again, any blanket removal makes little sense for publicly held firms. In the alternative, the charter could provide that management's agenda power over charter amendments is subject to *pro tanto* limitation in any case in which a shareholder proposes an amendment at a meeting. On the theory that the greater includes the lesser, this provision would be valid. On the other hand, if the agenda control provision were read as strictly procedural and not one of the 'business' matters under the basic statutory delegation, it would resist opting out and amount to a mandate. That reading follows from the structure of the state code. Since shareholder approval is mandatory for charter amendments, they are by hypothesis not within the 'business' in the exclusive delegation to management.

Finally, we question the applicability of Jensen and Meckling's historical *ex ante* pricing model to this case. That model presupposes a complete contract as to which all risk is priced out when the firm initially goes public. We think an incomplete contract model inclusive of *ex post* renegotiation of terms is more appropriate here. In practice, firms go public at an early, entrepreneurial stage of their life cycles. At that point, uncontrolled management influence over decisions creates value, and no one worries about independent directors and other process protections.²⁹² The shareholder participation movement deals with firms at a later stage of the life cycle-mature, solvent companies able to pursue failed strategies because of weak capital market constraints.²⁹³ To have present contracting processes determined by a risk allocation implied from a public offering of a quarter or half century earlier seems counterproductive.

In sum, state law's evolution to block shareholder access to the corporate contract may raise a presumption of efficiency, but a review of the history rebuts the presumption. At the turn of the century, when the agenda control provisions came into the corporate codes, corporate law was changing to facilitate investments of unprecedented scope by entrepreneurial managers. Today, the picture is more complicated. Some firms fit the paradigm of the productive management firm, but many do not. Until the recent occurrence of successful shareholder initiatives, the shareholder collective action problem made it pointless to question access barriers. The question finally comes up today in an economic environment in which we look to the legal framework to facilitate disinvestment as well as investment.²⁹⁴ The implication for the state code's access barriers is not efficiency, but obsolescence.²⁹⁵

²⁹² Indeed, a charter loaded with such terms might send a negative signal in an initial public offering.

²⁹³ See Black, *Agents*, *supra* note 30, at 832; Lipton & Lorsch, *supra* note 208, at 74-76.

²⁹⁴ See generally Michael C. Jensen, *The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems*, 48 J. FIN. 831, 847 (1993) (arguing that firms able to achieve disinvestment will be successful competitors in the coming era).

²⁹⁵ Gordon, *Cumulative Voting*, *supra* note 148, at 175-79, indirectly confirms this point. Gordon sensibly suggests that cumulative voting could facilitate implementation of institutional board membership. His proposal runs up against the access problem at the implementation stage: Since cumulative voting must be in the charter, and the proponent's only vehicle is the precatory proposal, chances for success are speculative at best.

4.14 Shareholder Access to the Charter for Process Amendments

4.14.1 Benefits

4.14.1.1 Shareholder Participation

We direct our access proposal to the pattern of discrete shareholder participation led by agents of public pension funds. We project beneficial consequences on the following model of engagement, abstracted from the practice pattern.²⁹⁶

Let us start with a proponent who publicly selects a corporate target and either launches a negative voting campaign or makes a precatory proposal. Public targeting indicates the proponent's judgment that the influence costs at the firm are unnecessarily high. If the proponent's determination has credibility, the targeting injures the reputations of the firm's managers and makes it more likely that the shareholders will obstruct future management proposals. The managers have three choices as to their response. First, they can take action amounting to a counter-signal showing that the proponent has selected incorrectly and thereby rehabilitate their reputations²⁹⁷

Second, if no such response is available and they are sufficiently risk averse with respect to reputation and shareholder relations, they can indicate responsiveness by starting a dialogue with the proponent. Third, they can do nothing

²⁹⁶ See supra notes 181-208 and accompanying text.

²⁹⁷ Recent events at Philip Morris show that this is possible. A board coalition (led by the previous C.E.O., a tobacco division veteran) formed to fight a proposal of the incumbent C.E.O. (a food division veteran backed by the institutions) to split the firm into its food and tobacco segments. This led to the incumbent's resignation and the selection of a new C.E.O. from the tobacco division. The new control group took its strategy to the marketplace, promising a more favorable dividend payout, and met a favorable response in the stock price—a two percent increase against a market decline on the announcement day. See Eben Schapiro, Philip Morris CEO Resigns Under Pressure, WALL ST. J., June 20, 1994, at A3; Eben Schapiro, Philip Morris Will Consider Stepping Up Buybacks or More Aggressive Dividend, WALL ST. J., June 22, 1994, at A3.

Thereafter, the institutions continued to pressure the firm, with mixed results. Philip Morris withdrew its poison pill in March 1995, responding to a 40% affirmative vote on a 1994 shareholder proposal. At the April 1995 annual meeting, 25% of the shareholders voted in favor of a proposal recommending limitations on benefits to outside directors. A Just Vote No Campaign initiated by CalPERS did less well, however—management's board slate was elected with a 96% vote. The C.E.O., meanwhile, continued to play the dividend card, promising a lower level of earnings retention. See Suein Hwang, At Philip Morris, 25% of Holders Vote to Slice Benefits of Outside Directors, WALL ST. J., April 28, 1995, at B4.

and let the campaign take its course.

Access to the charter gives the proponent more room to maneuver in the second and third cases. In the second case, the proponent gets a significant payoff only if the campaign's reputational effects are severe enough to cause realignment of the firm's internal coalitions and termination of the chief executive. Otherwise, dialogue leads to a payoff in the form of contract concessions. At the negotiations, the proponent has cost and reputational incentives to make a quick deal and take home some sort of contract modification. Management presumably will want to give up as little as possible in the way of concrete terms, consistent with an appearance of responsiveness. Management, in addition, at all times retains the option of noncooperation. The proponent, armed only with a precatory proposal and reputational threats, is not in a particularly strong position to extract meaningful concessions.²⁹⁸ If management has a pending proposal of its own, a credible negative voting campaign could mean a stronger bargaining position. Charter access lets the proponent go past the negative, which depends on management's agenda, and take its own mandatory agenda to the table. Armed with a mandate, the proponent with credible vote-getting ability can close off management's option of noncooperation. Furthermore, the mandatory stick can be wielded directly against the managers' influence within the firm as well as against their reputations: The proponent, for example, could go to the table with a new incentive compensation scheme that reduces the manager's rents.²⁹⁹ In the trade-off

²⁹⁸ Grundfest, *supra* note 32, at 932 n.354, noted that the importance of concessions extracted to date can be easily exaggerated. Confidential voting, as conceded by managers, tends not to apply in contested elections; decisions to redeem poison pills do not bar the board from adopting a new pill if the occasion arises.

²⁹⁹ A negative voting campaign also could have this effect if a compensation package were up for a vote. We note that the proposal in the example in the text is unlikely to be made in practice. Information costs would deter investment in a full-blown compensation proposal. Even if such an investment were made (or a simpler percentage cut in base salary were proposed), probabilities for passage would appear to be low even with respect to a manifestly underperforming company. Shareholder imposition of compensation terms that materially reduce management rents is tantamount to a no confidence vote, and presumably would be met in kind with reduced management efforts to reverse the fortunes of the firm. The proponent's purposes would be better served in the ordinary case with a proposal for a compensation committee, that is, a proposal packaged in pure process terms. On the other hand, a shareholder privilege to make compensation proposals, even uninvoked, retains a deterrent value. In addition, a substantive compensation proposal conceivably could be useful to a proponent in a case in which management has been recalcitrant, the outside directors have been passive, the shareholders have become noticeably dissatisfied, and no potential challenger for board control has appeared. In such a situation, a proposal might either promote management responsiveness, prompt a shakeup, or induce a control chal-

surrounding the proposal's withdrawal, the proponent can select from the whole agenda of process reforms.³⁰⁰

Charter access also could be useful in the case of a completely unresponsive firm. Precatory proposals have no governance consequences for managers willing to suffer the reputational consequences of noncooperation and risk the long-term consequences of poor shareholder relationships. Such a refusal to cooperate puts the proponent in a repeat play situation. Charter access lets the proponent raise the stakes in a second round, proposing an incentive compensation scheme, or an amendment that redeems a poison pill and calls for a shareholder vote as a condition of replacement. Such a punishment campaign would, we suspect, have to be carefully targeted,³⁰¹ with the proponents concentrating resources on a selected firm for a demonstration of enforcement power. A successful demonstration would reinforce the importance of shareholder relations and enhance cooperative incentives among the group of targets as a whole.³⁰² Charter access also holds out the possibility of short-term financial gain in some circumstances: Poison pill redemption can make the stock price go up if a takeover is a likelihood. The chance of gain might favorably alter the economics of subgroup formation, inducing private institutional players into the game on occasion.³⁰³

The utility of a bigger stick that holds out an intermittent financial incentive could increase over time. The current pattern of discrete intervention turns on reputational incentives on both sides. Reputational incentives can change with circumstances from period to period. Pension fund entrepreneurship could diminish in intensity if 'as the roster of players changes, the replacements discover that most of the available reputational gain has attached to the departed players of the first generation. Management reputational concerns also could change over time. The activists already have targeted the largest, worst-managed firms. New targets will represent less obvious cases of high influence costs, making noncooperative responses a more likely possibility. Old targets, meanwhile, become repeat play situations over time; as dialogue with institu-

lenge.

³⁰⁰ See *supra* note 208.

³⁰¹ A problem of information flow should be noted. A negative voting campaign involves minimal informational cost. Mandatory proposals lifted directly from the existing institutional agenda and fitting standing voting policies raise no significant informational problems for the proponent. A more complex proposal, such as a compensation scheme tailored to a particular company, would create more of a problem. Presumably, such a target would have to be selected with care, and the campaign well-publicized.

³⁰² Cf. Ayres & Braithwaite, *supra* note 13, at 45 (suggesting that occasional firing of big enforcement gun by a regulator might be more effective than frequent firing).

³⁰³ See *supra* notes 198-99 and accompanying text.

tions becomes an ongoing fact of life for these firms, reputational threats may loom less large and management's long-term concern about shareholder relations matter more. A power to expand the mandatory agenda allows the proponent to be more proactive.

4.14.1.2 State Law

Federally mandated charter access would ride atop the state system, giving the shareholders access to the corporate contract but not otherwise interfering with the production of state law. Taken alone, it would not impair the responsive benefits of the state system. Nor, taken alone, would it ameliorate the system's management bias. Accordingly, our definition of appropriate shareholder 'process' amendments would include reincorporation proposals. We would set up the following two-step process for shareholder-initiated reincorporation. First, the proponent's resolution would mandate the convening of a committee of independent directors that would, after consultation with an outside consultant,³⁰⁴ recommend a best alternative domicile. Second, the following year, the shareholders would vote on a resolution to approve or reject a move to the new jurisdiction. We employ the independent director intermediary to solve the problem of selection. Two proponents could suggest different states; a given proponent's choice could be uninformed or, conceivably, could result from a side-deal with actors in the jurisdiction chosen. In any event, public pension fund agents, being state employees, do not seem well-suited to this particular gatekeeper function. Of course, there remain possibilities for management influence over the independent directors. However, since we make this proposal more with a view to deterrent effects in states sensitive to incorporation business than with expectations of frequent utilization, we think the compromise workable.

The point of the shareholder reincorporation initiative, as stated above,³⁰⁵ is to provide state lawmakers with a long-term incentive to respond to shareholder interests. We doubt that it would result in any short-term disruption of today's charter market.³⁰⁶ No state presently stands out as a candidate for the role of shareholder-sensitive charter monger. Indeed, Delaware's laggard role as an antitakeover jurisdiction during the 1980s makes it a possible share-

³⁰⁴ Here we note possible income for legal academics.

³⁰⁵ See *supra* text accompanying notes 141A7.

³⁰⁶ Had a federal reincorporation mandate been on the books in 1980 along with a pattern of active shareholder participation, antitakeover legislation might not have become so widespread. A few well-timed reincorporations might have deterred management representatives from lobbying state legislatures because the shareholder interest would have garnered a more prominent profile in lawmaking processes.

holder-directed destination for firms located elsewhere. As a practical matter, then, the deterrent of shareholder-directed reincorporation would complement the federal threat,³⁰⁷ reinforcing Delaware's moderate legislative pattern and encouraging its judges in their attempts to mediate between the conflicting interests.

The burden to make use of initiative to invigorate the charter market would be on the shareholder proponents. To make active competition work here, they would have to expand their entrepreneurship to locate a jurisdiction, persuade it to go into competition and invest in an informed judiciary, draft an attractive code for it, and bring it some business. If all of that happened, Delaware would face a dual demand that could produce difficult choices. Moves in the direction of the shareholder interest to counter the threat of exit by established firms could cause the state to lose new business from entrepreneurial firms on the move to maturity, but such conflicts are the ordinary incidents of active competition.

4.14.2 Unintended Consequences

We have designed our proposal to avoid two possible unintended effects of shareholder initiative-rent seeking and vote cycling. Jeffrey Gordon, warning of both, has concluded that initiative is not cost beneficial. We argue that these concerns can be met through a subject matter limitation and a few ancillary process-rules.

4.14.2.1 *Rent Seeking*

On self-dealing, Gordon showed that, given concentrated shareholding and unlimited access to the charter, there would arise a risk of logrolling effected through shareholder side agreements that direct the firm to suboptimal projects benefiting the shareholders' businesses. Given dispersed shareholdings, Gordon projected that the problem might arise whenever a substantial proportion of the group of holders represents a distinct unity of interest-as when union and public pension funds, or members of some political or economic interest group, hold a large proportion of the stock.³⁰⁸ This latter scenario would be unlikely to arise in the present context, given prevailing institutional diversification

³⁰⁷ We would not expect this form of federal intervention to defuse the ongoing threat. Any congressional move against the state system, however minimal, would break a conceptual federalism barrier and imply the possibility of further intervention in the event of significant state developments attributable to management influence. The short-term effect, then, probably would be one of reinforcement.

³⁰⁸ See Gordon, *Shareholder Initiative*, *supra* note 29, at 376-79.

practices and rational apathy among small holders. However, Gordon also noted that the advent of a regime of unlimited access could cause holding patterns to change. At present, American firms having large block holders tend to have only one such holder. That holder gains influence over management and deters others from accumulating large blocks.³⁰⁹ Unlimited access opens up possibilities for hostile coalition-building by latecomer block holders, inviting a change in the shareholding pattern.

We agree that the risks Gordon described are cognizable and have little confidence that present fiduciary law could effectively limit them. Accordingly, we leave matters of investment and disinvestment out of our access proposal to delimit its utility to actors engaging in governance activity in pursuit of short-term financial gain. The practical cost to the shareholder participation movement, as presently directed, is the foreclosure of direct action respecting disinvestment and corporate unbundling. Here, again with Gordon, we think that dialogue and process reform work better.³¹⁰

It must be noted that the process and structure limitation diminishes incentives for side deals without ensuring their absence. Return to the above example of a proponent who threatens management with a new, rent-reducing, incentive compensation scheme. Although defined as process and structure, the proposal remains susceptible to withdrawal in exchange for a side-payment.³¹¹ The guarantee against such a transaction lies not in the subject matter limitation but in the proponent's projected incentive profile. So long as the proponent comes to the role seeking reputational rather than financial capital, trade-offs will be structured with a view to reputational gain. Thus, a pension fund entrepreneur concerned with vote-getting credibility can be expected to structure trades that entail a concrete shareholder-beneficial component.³¹²

³⁰⁹ See *id.* at 374 (citing Harold Demsetz & Kenneth M. Lehn, *The Structure of Corporate Ownership: Causes and Consequences*, 93 J. POL. ECON. 1155 (1985)).

³¹⁰ Interplay between unbundling and process reform can be hypothesized. The proponent wants the firm to divide itself in two or spin off a substantial subsidiary. The proponent is motivated by current conventional wisdom and is ill-informed. Management resists. The proponent threatens management with poison pill redemption or incentive compensation. If management concedes, the firm is unbundled. If management resists, the proposal goes to a shareholder vote.

We do not view this possibility as problematic. In the latter case, the proponent still has the substantial task of persuading the shareholders of the merits of the process proposal. The proponent's inadequate information about unbundling does not bear directly on that matter. In the former case, management will have had an opportunity to inform the financial community of its case. If the case resonates, management has no reason to concede.

³¹¹ We thank Jeffrey Gordon for noting this point.

³¹² Certainly, a secret financial component could be a part of such a trade. But the

Any additional consideration sought by this actor will more likely take the form of influence within the firm than the form of rent. Influence within the firm, unlike money, gives this actor opportunities for further reputational enhancement and at least holds out a prospect of shareholder benefit. At the same time, even an undisclosed rent deal creates a risk of reputational injury for the proponent.³¹³

4.14.2.2 Cycling

On the problem of voting cycles,³¹⁴ Gordon hypothesized corporate versions

inclusion of such a component would not necessarily mean that the overall trading process was detrimental to shareholder interests.

³¹³ And for the target making the offer: Third parties report that managers at Philip Morris, a leading institutional target, recently offered a job to Richard Koppes, the Deputy Executive Director of CalPERS. Koppes turned down the offer. See Glenn Collins, Philip Morris Meeting Subdues Tobacco Protest, N.Y. TIMES, April 28, 1995, at D3.

This calculus might change during an end period, but the reputational deterrent should still exercise influence. An actor might leave state service for the private money management sector, or leave one state office to assume or run for another. In either case, later exposure of a questionable trade could prove injurious. On the other hand, a pension fund agent looking to a career in state politics might have a reputational incentive to trade for a geographically specific benefit, such as the location of a plant in his home state. But the conflict of interest still bespeaks a need for secrecy, limiting the potential for political reputational enhancement at home. Only an actor building a personal account for a projected retirement seems to present a strong risk.

It also must be noted that a process and structure access privilege could provide the medium for a threat by a financially-motivated actor. For example, a hostile large blockholder could use a management compensation proposal (whatever the identity of the proponent) as the occasion for negotiations keyed to rent extraction. But this possible abuse, like that of rent extraction by a political entrepreneur, exists in the present legal structure. Indeed, the blockholder's opportunities to extract rents follow from the very existence of the shareholder vote. An access proposal limited to process and structure does create additional occasions for rent demands, but we doubt that it would so alter the underlying economics as to induce blockholding in the first instance or provide a blockholder with a rent extraction opportunity that could not arise otherwise. Thus, at the bottom line, our proposal's incremental aspect comes into the appraisal of the self-dealing risk that attends it. Limited shareholder access serves mainly to strengthen the bargaining position of one party in an established bargaining situation. The side deal possibility exists already and is, indeed, intrinsic to any shareholder empowerment strategy.

³¹⁴ Social choice theory, which began with Kenneth J. Arrow, *Social Choice and Individual Values* (2d ed. 1963), asserts that 'majority rule can lead to any economically and technically feasible outcome. Even if voters are other-regarding, so long as their preferences differ, voting results will be unstable. Furthermore, there will be no basis for assuming that

of a standard Arrovian voting cycle³¹⁵ under unlimited shareholder access. In his base case, we have three shareholders, each of whom owns twenty-six percent. The issue is unbundling. One wants to sell a division; the second wants the status quo; and the third wants a spin off. The preferences are ordered, and a majority voting cycle results. The same, of course, could follow with dispersed shareholdings.

However, voting cycles can be contained by process institutions. Critics of social choice theory point out that its models suffer from significant limitations; cycling becomes a problem only in the simplest of majority rule institutions—without agenda controls, without strategic voting, and with an agenda constructed on an ongoing basis; in practice, agenda-setting institutions and agent sophistication constrain majority outcomes.³¹⁶ So long as actors in voting

voting results are connected with the preferences of the electorate. *Id.* at 22-33, 7-120; see also Richard D. McKelvey, *Intransitivities in Multidimensional Voting Models and Some Implications for Agenda Control*, 12 J. ECON. THEORY 472, 480 (1976) (discussing global cycling theorem which shows that when majority rule breaks down, any two points in space will belong in a cycle).

³¹⁵ Given majority rule, it is possible to cycle through different preferences. Assume that there are three players, A, B, and C, and three alternative outcomes, a, b, and c, and the following preference rankings:

A:abc
B:bca
C:cba

The result is a classic voting paradox, that is, a lack of transitive social ordering.

Cycling occurs by virtue of the actors' preferences remaining fixed over time. With multiple issues to be resolved simultaneously by a large number of decisionmakers, social choice models show that cyclical majorities will occur in two-thirds of the decision contexts, so long as logically ordered preferences are likely to emerge.

³¹⁶ See Shepsle & Weingast, *supra* note 258, at 69; see also Kenneth A. Shepsle, *Studying Institutions, Some Lessons from the Rational Choice Approach*, 1 J. THEORETICAL POL. 131, 135 (1989) (arguing that cycling majorities are not a major problem).

For a survey of the anticycling literature containing a useful taxonomy of explanations for stability or induced equilibrium, see Donald P. Green & Ian Shapiro, *Pathologies of Rational Choice Theory: a Critique of Applications in Political Science* 11-20 (1994). Green and Shapiro divide the existing accounts into three groups. The first contends that equilibrium results from information costs and legislative specialization caused by the existence of a system of permanent committees. The second school of thought holds that induced stability results from a range of special preference formation—for example, a quasiconcave preference distribution in connection with a supermajority voting requirement. The third group, which includes Shepsle and Weingast, asserts that stability stems from institutional arrangements. Green and Shapiro add a few additional factors to the catalog drawn from outside the confines of rational choice theory: computational difficulty, political infeasibility,

institutions take full advantage of strategic opportunities available to them under those institutional rules, majority-rule voting cycles are unlikely.³¹⁷ Gordon, heeding this literature, acknowledged that the cycling problem attending charter access could be ameliorated with a process device that orders the agenda. He considered the possibility of a rule that lets management set the agenda, as between the three shareholder proposals. He rejected that device on the ground that management ends up controlling the result, effectively returning us to absolute delegation.³¹⁸ We note in response that the device of the independent director committee could be drawn on instead. The procedure would be the same one we propose for reincorporation. The shareholder proposes the formation of a committee to consider the best means of unbundling the firm; the committee reports back with its best proposal; the shareholders vote yes or no, with no being a vote for the status quo. Since a choice must be presented, management's agenda control is broken. The special committee serves the same cycle-breaking function here as does the legislative committee. Of course, it would not guarantee the result of effective shareholder choice. The committee could resort to subterfuge to get the result management wants, reporting a manifestly unpalatable alternative to the status quo. However, the initiative is destabilizing nonetheless. The initial shareholder vote to convene the committee signals that divisions of the firm may be up for sale. If the signal were to attract a third-party offer, suppression by the special committee would be substantially constrained.³¹⁹

Given the availability of a process rule that restricts shareholder choice, we are not at all sure that cycling need be a problem with respect to initiatives on investment and disinvestment. As Gordon also noted,³²⁰ however, consistency over time might be such a problem: Shareholders could decide to invest in one period and disinvest in the next period, with costly results. Given the problem of asymmetric information, and the possibility of rent-seeking on the side, we conclude that the risks attending initiative on matters of investment and disinvestment are prohibitive.

Cycling could in theory occur with process and structure matters, even though the immediate financial incentives that motivate the shareholders in

and a regime of metapreferences that works to avoid conflict.

³¹⁷ Ole-Jorgen Skog, 'Volonte Generale' and the Instability of Spatial Voting Games, 6 *Rationality & Soc.* 271, 282-84 (1994), argue that McKelvey's theory of global cycling depends on the assumption that individuals are able to discriminate between alternatives that are very close. In Skog's view, this assumption is unrealistic; if it is relaxed the general instability of two-dimensional spatial voting games disappears.

³¹⁸ See Gordon, Shareholder Initiative, *supra* note 29, at 363-64.

³¹⁹ See cases cited *supra* note 117.

³²⁰ Gordon, Shareholder Initiative, *supra* note 29, at 364-65.

Gordon's examples would be absent. Conceivably, one proponent could propose a compensation committee, a second could propose a specific, self-executing investment compensation scheme requiring no committee, and a third could propose a compensation scheme resembling the status quo. However, no cycling would occur here under our proposal, even though it would open the door to any proponent or group of proponents meeting a threshold percentage ownership requirement. We have included a process rule that prevents cycling:³²¹ Proposals only may be considered at the annual meeting, and under the proxy voting system, proposals are submitted for a one-round majority vote. The problem stemming from unlimited access would not be cycling but inconsistency of result—for example, both the status quo based and the new compensation scheme could be approved. A breaker rule could be included to deal with this problem. If management deems two proposals to be inconsistent, it refers the matter to a third-party adjudicator. If the proposals are then found to be inconsistent, the first in time reaches the agenda.³²² Two candidates are available for this adjudicatory role—the SEC staff and the independent directors' committee. We prefer the latter in theory, but since any disputed matter would find its way to the SEC staff in any event, the former amounts to the practical choice. In either case, a result is reached and there is no cycling. One problem remains: the possibility of inconsistency over time³²³ and attendant costs.³²⁴

³²¹ Steven J. Brams, *Theory of Moves* 187-93 (1994) (showing that there are very simple ways to employ process rules to break voting cycles).

³²² Here, a possibility for management manipulation opens up. If management hears of a proposal, it arranges with a friendly shareholder to propose an inconsistent proposal first. Assume that management wants to block a proposal for a compensation committee. The management nominee would propose that the charter, which says nothing about compensation committees, be amended to say the corporation shall not have a compensation committee. The result is the status quo on either a yes or a no vote. To avoid this problem, proposals that have a status quo effect would have to be excepted from the first-in-time rule.

³²³ This problem easily could be treated with a provision that bars, for a period of years, any subsequent shareholder initiative on the subject matter covered by a successful initiative.

³²⁴ An extension of our proposal toward the territory of investment and disinvestment should now be suggested. Access could be granted to amend the charter to broaden the statutory list of transactions that must be submitted for shareholder approval. Under such an access permission, shareholders could require voting for acquisitions effected under triangular mergers, large asset purchases, and other significant transactions that presently can be effected in the boardroom in many states. Such an expanded voting regime is extensively discussed as a mandatory proposition in Lynn L. Dallas, *The Control and Conflict of Interest Voting Systems*, 71 N.C. L. REV. 1, 47-71 (1992); see also Rock, *Dark Side*, *supra* note 161, at 1023 (noting shareholder approval of special issue of preferred stock).

We think the consistency problem is minimal, even absent a breaker rule. We envision a percentage ownership requirement keyed to institutional holding patterns and set high enough so that two or three institutions must coordinate their efforts in support of the proposal. The idea is to rely on the practice pattern to ensure process coherence. The leading players in the shareholder participation movement have been motivated by reputational gain.³²⁵ Process and structure initiatives that lead to conflicts with other institutional players hold out little prospect of reputational enhancement.³²⁶

Furthermore, in a case in which a proposal responds to a bargaining impasse with a long-term target or complete noncooperation from a new target, one would anticipate coordination and information sharing among the institutions involved in the campaign.³²⁷ Finally, since reputational gain here ultimately depends on vote-getting ability, we would expect proponents to select their proposals and targets with care.³²⁸

Under a more aggressive form of this extension, the shareholders would have a privilege to legislate not only a veto but a right of initiative. For example, a charter provision might permit initiation of a merger or asset sale. At this point the line between process and structure and substance is breached very clearly.

³²⁵ See *supra* text accompanying notes 200-08.

³²⁶ Cf. *Brams*, *supra* note 320, at 118-19. *Brams* notes that reputation and moving power are best understood in the same light: Where a player establishes a reputation and the reputation is acknowledged by an opponent, 'it may no longer be necessary for players physically to cycle to 'prove' themselves. Mental moves will then suffice, and a player with recognized moving power may then get its way without suffering the costs of actually cycling.' *Id.*

³²⁷ Here we draw by analogy on *Shepsle & Weingast*, *supra* note 258, at 64-69. *Shepsle* and *Weingast* argued that legislative outcomes are not in flux, but display systematic regularities, due in part to the disproportionate influence on outcomes of members of powerful committees. Certain members, by virtue of the control over process derived from their committee positions, are able to translate their preferences into legislative action. *Shepsle* and *Weingast* call this 'structure-induced equilibrium', which means that an institution can be modelled as an extensive form game due to the combination of process sequence and the identity of the individual players. At the bottom line, the structure-induced equilibrium is an alternative that is invulnerable. The earlier social choice models, in contrast, relied on an atomistic structure lacking the features essential to understanding the nature and distribution of the actors' preferences.

³²⁸ We make this proposal for limited federal intervention without an expectation of a favorable political climate. In fact, the proposal contains a takeover-friendly aspect that would make it politically controversial. Shareholders could use it to force poison pill redemption or to opt out of state antitakeover statutes containing open-ended opt-out provisions. See *Del. Code Ann.* tit. 8, § 203(b)(3) (1991).

Since access would facilitate shareholder defection in the event of a takeover, it also

4.15 Conclusion

This Article began by comparing the regulatory strategy of enforced self-regulation with the historic alternatives of market and fiduciary deterrence, commending self-regulation as a means to cooperative solutions to corporate agency problems. Having surveyed the emerging self-regulatory field, and after making a proposal for its expansion, we close by noting the modesty of the benefits we project. An experiment with process and structure access very well might result in no significant changes, either due to sporadic utilization of the access privilege, or a cooperatively based response by the larger group of shareholders against the forcing of governance terms on managers, except in extreme, end-period situations. In the alternative, extensive and underinformed utilization could conceivably cause incentive or other contractual problems in given firms. However, We think management has sufficient resources and enough of an informational advantage to protect firms from this problem. On our most sanguine projection, charter access, used responsibly and occasionally, would bring process rules that lower management influence costs to a small group of mature firms. Our hope is that competitive evolution would then take its course, so that other firms voluntarily adopt the rules that work best. From there, we would hope that responsible and occasional use of charter access encourages ongoing contractual innovation, with all players contributing: institutional agents, managers, and lawyers.

Some years ago, a corporate law debate over the desirability of mandatory and enabling rules came down to simple difference of opinion. The enabling side emphasized the importance of innovation and flexibility; the defenders of mandates emphasized process infirmities. The discussion here goes back to that point of difference. State law has done an excellent job of assuring that firms can draft contracts that accord managers freedom of action to invest and disinvest, but it has not evolved to open up all possibilities for productive firm contracting. State law remains the best vehicle for realizing those possibilities, but a demand-side barrier prevents state law experimentation. An incidental federal intervention taken to facilitate the experiment will not hurt the state system, and it might do the system some good.

would do nothing to ameliorate the problem that takeovers present for relational shareholder participation strategies.

CHAPTER 5

THE NEW ECONOMICS OF JURISDICTIONAL COMPETITION: DEVOLUTIONARY FEDERALISM IN A SECOND-BEST WORLD¹

5.1 Introduction

Our federalism has entered a devolutionary phase.² We see this in the political rhetoric of federal deregulation,³ in new legislation like the 1996 welfare reform act,⁴ and in academic discussions.⁵ Under the emerging majority view, relative regulatory advantage within the federal system lies with state and local government. This reverses a conventional wisdom favoring federal solutions that dates back to the New Deal. The shift results from the confluence of many patterns of thought and action, political, social, legal, and economic. This Article takes a new look at the last two factors, law and economics, at the point where they come together to articulate a theory of federalism known as jurisdictional competition.

Legal federalism looks to the economic theory of jurisdictional competition to provide decisive support for devolutionary initiatives. Under the prevailing story, the economic theory makes two general assertions, which in turn give rise to three powerful normative implications for federalism. The two assertions are said to be these: (a) Competitive forces shape a wide range of outcomes at state and local levels because public goods and regulations figure significantly in the locational decisions of citizens, factors of production, and

¹ This chapter appeared (with William W. Bratton) in *Georgetown Law Review* 1997.

² See Peter H. Schuck, *Introduction: Some Reflections on the Federalism Debate*, YALE L. & POLICY REV./YALE J. REG. SYMPOSIUM ISSUE 1, 5-9 (1996).

³ See, e.g., CONTRACT WITH AMERICA (Ed Gilliespie & Bob Schellhas, eds. 1994).

⁴ Personal Responsibility and Work Opportunity Reconciliation Act of 1996, Pub. L. No. 104-193 (replacing Aid to Families With Dependent Children with block grants to the states).

⁵ See, e.g., YALE L. & POL'Y REV./YALE J. REG. SYMPOSIUM ISSUE (1996).

capital;⁶ and (b) The competition results in a market that brings regulatory outcomes and citizen preferences into a first-best equilibrium⁷ and thereby provides an 'empirical answer' to important policy questions,⁸ since only public goods and regulations for which citizens are willing to pay will survive in the long run.⁹ The normative implications for legal and political theory are said to be these: (a) Just as price competition disciplines producers of private goods for the benefit of consumers, so competition will discipline government producers for the benefit of taxpaying citizens; (b) Central government should be seen as a cartel: Just as collaboration among competing producers of products reduces price competition and incentives to innovate, so the removal of regulatory subject matter to a central government reduces the number potential competitors and dilutes entrepreneurial incentives; and (c) Since federal intervention, whether by congressional legislation¹⁰ or judicial decree,¹¹ thus inhibits the operation of the market, it is at best unnecessary

⁶ See Barry R. Weingast, *The Economic Role of Political Institutions: Market Preserving Federalism and Economic Development*, 11 J. L. ECON. & ORG. 1, 5 (1996).

⁷ Two conditions must obtain, however — the junior level regulation must not generate significant externalities and borders must remain open for the free movement of capital and labor. See, e.g., Frank H. Easterbrook, *Federalism and European Business Law*, 14 INT'L REV. L. & ECON. 125, 127, 129 (1994); cf. Thomas W. Merrill, *Chief Justice Rehnquist, Pluralist Theory, and the Interpretation of Statutes*, 25 RUTGERS L. J. 621, 640 (1994) (interjurisdictional spillovers and consequent races to the bottom limit the beneficial effects of regulatory competition).

⁸ See Steven G. Calabresi, 'A Government of Limited and Enumerated Powers': in *Defense of United States v. Lopez*, 94 MICH. L. REV. 752, 776 (1995). And, even where the conditions for a first best equilibrium outcome do not obtain, the possibility of competition will lead to beneficial experimentation and regulatory differentiation. *Id.* at 777. Cf. George Wyeth, *Regulatory Competition and the Takings Clause*, 91 NW. U. L. REV. 87, 88, 91, 92-94 (1996) (employing the 'hypothetical' competitive outcome as the basis for determining the existence of a regulatory taking).

⁹ See Weingast, *supra* note 6, at 5. A jurisdiction, accordingly, will regulate only if the political benefits of the regulation are worth the costs imposed by exiting actors. *Id.* at 6.

¹⁰ See, e.g., Jacques LeBoeuf, *The Economics of Federalism and the Proper Scope of the Federal Commerce Power*, 31 SAN DIEGO L. REV. 555, 556 (1994) (exercise of the federal commerce power appropriate only where state regulation of commerce causes inefficient externalities); Richard Revesz, *Rehabilitating Interstate Competition: Rethinking the 'Race-to-the-Bottom' Rationale for Federal Environmental Regulation*, 67 N.Y.U. L. REV. 1210, 1244-45, 1253 (1992) (presumption favoring environmental regulation at the state level).

¹¹ See Vicki Been, 'Exit' as a Constraint on Land Use Exactions: *Rethinking the Unconstitutional Conditions Doctrine*, 91 COLUM. L. REV. 473, 511 (1991) (arguing against federal constitutional scrutiny of municipal land use decisions and concluding that, given regulatory competition, those who would constrain municipal power have the 'burden to explain' why

and at worst results in deadweight anti-competitive costs. At the bottom line there arises a strong presumption in favor of locating regulatory authority with junior levels of government.

This Article shows this story to be false in crucial respects, and, in some tellings, even a little silly. The weakness lies in the source. The story relies on a model of jurisdictional competition whose robustness long has been questioned by advanced opinion in its own field. In response to these questions economists have modified their approach to the analysis of competitive behavior among governments. They still emphasize the advantages of state and local regulation. But the new economics of federalism they articulate operates on a level of complexity that precludes global pronouncements about the location of relative regulatory advantages within the federal system. In an all-or-nothing debate between centralization and devolution, it supports neither side.

The new economics thus withdraws support from legal federalism's general assertion that devolution of regulatory authority to the state and local level leads to competitive efficiency. It instead assists us in addressing the strengths and weaknesses of particular regulatory initiatives, centralizing or devolutionary as the case may be. It does not preclude reference to the benefits of jurisdictional competition in policy debates. But it does reallocate the burden of showing these benefits to the proponent of a novel junior level, competitive solution. Two showings must be made to import plausibility to such a claim: (a) Since devolution does not by itself assure that competition will determine the terms of regulation, the presence of conditions conducive to competition must be shown affirmatively; and (b) Since regulatory competition, if and when it occurs, does not by itself assure identity between lawmaking and citizen preferences, proponents should describe (or project) a chain of causation. This should begin with a statement of particular competitive pressures. The proponent should go on to show how the pressures impact on the alignment of interest group politics and other factors that influence regulatory outcomes in the competing jurisdictions. The proponent then should show the path from the politics thus described to a regulatory outcome.

These economic lessons have not yet been assimilated into legal federalism discussions. It is important that this deficient understanding of the interconnection between economic theory and state and local regulation be remedied, especially at a time of new devolutionary initiatives. This Article

market forces do not provide adequate discipline).

begins the job.¹²

Part I situates jurisdictional competition theory in the larger contexts of legal federalism and public choice theory. This discussion begins with the classic Tiebout model of public goods provision¹³ and goes on to describe its expansion into a model of regulatory competition in legal contexts. The discussion then fixes the Tiebout model's place in public choice theory. This analysis shows that jurisdictional competition theory's special attractions are its claims to yield a first-best equilibrium outcome and to provide a mechanism that cures state and local regulatory capture problems. These claims outstrip those of concomitant devolutionary theories articulated elsewhere in public choice and public economics. Finally, Part I describes the structure and posture of legal federalism's debate between race-to-the-top and race-to-the-bottom views of jurisdictional competition, commenting that neither side offers a useful approach for projecting the economic results of devolution.

Part II is a sustained examination of the economics of the Tiebout model's shortcomings. This discussion shows first, that public economics has never managed to derive a stable equilibrium model of competing jurisdictions that meaningfully describes the real world (or any reasonably approximate hypothetical substitute). Theoretically speaking, this is a devastating development for the economics of devolution. The absence of a base in a stable equilibrium model leaves the theory to commend a bizarre sort of federalism in which central government must intervene to stabilize a dysfunctional, unpredictable market. The discussion goes on to show that such a central authority would have its hands full devising mechanisms to ameliorate frictions that inhibit the Tiebout model's operation — limited information, externalities, and the costs of mobility. Finally, Part II highlights the hollowness of the model's assumption that government actors have incentives to act entrepreneurially. This turns out to be the biggest sticking point on the list. Without a credible description

¹² Two recent articles also draw on the new economics of regulatory competition, avoiding the practice of viewing regulatory competition as an all-or-nothing proposition. See Louis Kaplow, *Fiscal Federalism and the Deductibility of State and Local Taxes Under the Federal Income Tax*, 82 VA. L. REV. 413, 420 (1996) (reserving decision on the question of the efficiency consequences of deductibility of state and local taxes for federal income tax purposes); Robert Howse & Michael J. Trebilcock, *The Fair Trade-Free Trade Debate: Trade, Labor, and the Environment*, 16 INT'L REV. L. & ECON. 61 (1996) (taking a complex approach to analysis of trade-offs between free trade and environmental and labor standards). This Article is the first to discuss the implications of the new economics of regulatory competition for the broader legal theory of federalism.

¹³ Charles Tiebout, *A Pure Theory of Local Expenditures*, 64 J. POL. ECON. 416 (1956).

of lawmaker incentives, the model cannot make on good on its claim provide a mechanism that beneficially disciplines government and eliminates public choice problems.

Part III introduces the new generation of formal models of jurisdictional competition to the legal literature. These models redeploy the theory in a second-best world. In so doing they sap the strength from the efficiency claims made in legal federalism heretofore. Externalities, universally understood to be a legitimate ground for federal intervention under the model, turn out to be implicated in most state and local decisions to tax and provide public goods. The job of qualifying a devolutionary initiative on productive grounds becomes much harder as a result. The new economics also includes a search for new mechanisms that shore up the old model's deficiencies. These models address problems of information asymmetry and regulatory capture at the state and local level that the old model assumes away. Ironically, politics and voting, purportedly irrelevant under the old model, come back into the picture as a more plausible model is cobbled together, piece by piece.

Part IV articulates the economics' implications for legal federalism. This discussion recommends, first, a five-step suitability standard for legal applications of the theory, and, second, that the shopworn and misleading concepts of a race-to-the-top and a race-to-the-bottom be retired. Part IV goes on to extend the lessons of the economic models, which for the most part concern local public goods production, to a range of regulatory competition situations. This discussion offers a typology showing that the model applies with greater robustness than is the case with local public goods in some regulatory competition situations, but applies in others with its problematics unabated.

I. THE JURISDICTIONAL COMPETITION PARADIGM

A. The Tiebout Model and Its Reception to Legal Federalism

1. *The Tiebout Model*

— The economic theory of jurisdictional competition addresses the production of public goods¹⁴ — the actual goods and services produced by government

¹⁴ Technically, a pure public good is a good as to which consuming individuals cannot be excluded in the event they fail to provide their *pro rata* share of the rent required for

for which citizens willingly pay rents, such as national defense, police and fire protection, roads and sewers, and public education. Under the 'Samuelson condition' for public goods allocation, efficient public goods production occurs when the sum of a citizen's marginal rate of substitution of income for the good is equal to the marginal cost of an additional unit of the good. The Samuelson condition is not easily met. With private goods, market competition forces producers to keep down their marginal costs and market prices provide concrete information about consumers' rates of substitution. With public goods, in contrast, there is no obvious market that constrains government producers to keep marginal costs down. Nor is there an obvious mechanism that forces taxpaying citizen-consumers to tell the truth about their rate of substitution.¹⁵

Charles Tiebout's model of regulatory competition purports to identify a mechanism that satisfies the Samuelson condition, importing discipline to government producers and matching citizen preferences to levels of public goods provision and taxation.¹⁶ The mechanism is a market — a market for public goods in which competing local governments seek to attract a customer base of mobile taxpaying citizens.¹⁷ Tiebout's model depicts citizen-voter

production. The provision of public goods, thus defined, economically justifies the existence of government: Given free rider problems, their producers are unable to capture some or all of their production cost, and they will be undersupplied absent a taxation mandate. Assessment of a good's status as a public good entails examination of a range of factors, such as the feasibility of exclusion, the properties of demand, and the costs and distributional implications of individually-based supply. See ANTHONY B. ATKINSON AND JOSEPH E. STIGLITZ, *LECTURES ON PUBLIC ECONOMICS* 486 (1980). See also Paul A. Samuelson, *The Pure Theory of Public Expenditures*, 1954 REV. ECON. & STAT. 387. In this Article, the term 'public goods' includes (a) goods conventionally provided by local government in addition to pure public goods, and (b) public services.

¹⁵ The free rider problem that comes up in the arena of collective political action makes it rational for citizens to misstate the level of their demand. See Paul Samuelson, *The Pure Theory of Public Expenditure*, 34 REV. ECON. & STAT. 387 (1954). Demands will be overstated or understated depending on the individual's projection of required payments. For example, an actor will overstate his or her demand if the actor believes that the demand leaves his or her level of payment unaffected, and the additional cost of providing the good will fall on others. See Theodore Groves, *Incentives in Teams*, 41 *ECONOMETRICA* 617 (1973).

¹⁶ Tiebout, *supra* note 13.

¹⁷ The model has been subsequently developed and refined. See, e.g., James M. Buchanan & C.J. Goetz, *Efficiency Limits of Fiscal Mobility: An Assessment of the Tiebout Model*, J. PUB. ECON., Apr. 1972, at 25; WALLACE E. OATES, *FISCAL FEDERALISM* (1972); William A. Fischel, *Fiscal and Environmental Considerations in the Location of Firms in Suburban Communities*, in *FISCAL ZONING AND LAND USE CONTROLS* 119 (Mills et al. eds,

choices respecting local public goods in the context of a city resident contemplating a move to the suburbs and choosing among a number of towns.

The model's results depend on a series of assumptions:¹⁸ (a) there exists a large number of communities, and the public goods offerings of each reflect the full range of public goods available; (b) mobility is costless for all relocating actors, who choose a jurisdiction based on taxes and available public goods; (c) perfect information is available respecting the public goods on offer in all jurisdictions; (d) every jurisdiction has an optimal size, defined as the number of residents for which the bundle of services can be produced at the lowest average cost, (e) communities below the optimal size will seek to attract new residents in order to reduce the average cost of providing services; and (f) there are no externalities, monopolies or spillover effects across jurisdictions. We will see in Part II that the problems with the model's robustness stem from the difficulty of relaxing these assumptions.

With the assumptions in place, the Tiebout model makes two assertions. First, it claims a tie between citizen mobility and preference revelation and predicts that locational decisions will reveal individual preferences for public goods and levels of taxation. Rational forward-looking individuals, after surveying the range of available choices, will act in accordance with their preferences for location-specific bundles of public goods. Second, the model claims that this preference revelation process leads to a market equilibrium. This local public goods equilibrium will be established since, like producers of private goods and services, local government units will compete with their public goods offerings to attract in-migration. Competition between local governments thus should be promoted because it will lead to an optimal balance between the level of taxation and the provision of public goods.

2. *Extension to Regulation*

— The Tiebout model influenced its own field profoundly.¹⁹ Public econom-

1975).

¹⁸ Among others. The model also assumes that the preferences of relocating actors are not influenced by the presence or absence of employment opportunities.

¹⁹ Somewhat contradictorily, it also supports a set of autonomy oriented policy prescriptions designed to enhance the chance that local level competition respecting public goods production actually occurs. See Richard Briffault, *Our Localism: Part II — Localism and Legal Theory*, 90 COLUM. L. REV. 346, 403 (1990). Related arguments have been made in legal discussions of local government and land use. See, e.g., Robert C. Ellickson, *Cities and Homeowners Associations*, 130 U. PA. L. REV. 1519, 1543-44 (1982) (owner associati-

ists have been producing formal models of jurisdictional competition ever since it appeared in 1956. But, as Part II of this Article will show, strategies for dealing with the model's lack of robustness have been the primary concern during the latter part of this period.

The original model has fared better in recent years on the interdisciplinary playing field of law and economics, where the rigors of formalization are relaxed and normative concerns predominate. In further contrast to model's development in its home field, where it has remained closely tied to the study of the production of local public goods, it has been applied in legal contexts to a broad range of subject matter. These extensions take the public goods concept to government's output of regulation in addition to its output of actual goods and services. Under the expanded view, the public consumes and pays for regulatory outcomes such as contract enforcement, clean air, safe products, and stable labor relations. Government is just another producer in the overall economy, and law is product.

The Tiebout model came to legal federalism early in the history of law and economics. Local government law and associated real property topics were the first applications.²⁰ The extension to regulation then enabled the model's application to corporate,²¹ banking,²² and environmental law,²³ with

ons); Been, *supra* note 11, at 543-44 (arguing against judicial scrutiny of land use exactions). *But see* Stewart E. Sterk, *Competition Among Municipalities as a Constraint on Land Use Exactions*, 45 VAND. L. REV. 831, 844-45, 850, 857-58 (1992) (arguing that municipalities have rent-extraction capacity despite competition).

²⁰ See Note, Frederick T. Goldberg, *Equalization of Municipal Services, The Economics of Serrano and Shaw*, 82 YALE L.J. 89, 89-105 (1972) (applying the Tiebout model to argue against judicially imposed per capita equality in respect of public goods provision by local government); *see also* BRUCE ACKERMAN, *ECONOMIC FOUNDATIONS OF PROPERTY LAW* 247-65 (1975); Robert C. Ellickson, *Suburban Growth Controls: An Economic and Legal Analysis*, 86 YALE L.J. 385, 506 & n. 404 (1977) (citing Tiebout as supporting ideal of a variety of public goods).

²¹ See Ralph Winter, *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251, 254-58 (1977).

²² See Scott, *The Dual Banking System: A Model of Competition in Regulation*, 30 STAN. L. REV. 1, 1213 (1977).

²³ See Richard B. Stewart, *The Development of Administrative and Quasi-Constitutional Law in Judicial Review of Environmental Decisionmaking: Lessons from the Clean Air Act*, 62 IOWA L. REV. 713, 714-22 (1977) (hereinafter Stewart I) (race-to-the-bottom view of regulatory competition); Richard B. Stewart, *Pyramids of Sacrifice? Problems of Federalism in Mandating State Implementation of National Environmental Policy*, 86 YALE L. J. 1196, 1212 (1977) (same).

antitrust²⁴ and product safety following soon thereafter.²⁵ The cumulated applications²⁶ transformed federalism theory.²⁷ Jurisdictional competition came to be acknowledged as a basic federalism value,²⁸ joining the list of more traditional concerns.²⁹

²⁴ See Frank H. Easterbrook, *Antitrust and the Economics of Federalism*, 26 J. L. & ECON. 23, 23-25 (1985).

²⁵ See David A. Rice, *Product Quality Laws and the Economics of Federalism*, 65 B. U. L. REV. 1, 1-3 (1985).

²⁶ The law as product field is still 'booming'. Carol M. Rose, Book Review, *Takings, Federalism, Norms*, 105 YALE L. J. 1121, 1133 (1996) (reviewing WILLIAM A. FISCHER, *REGULATORY TAKINGS: LAW, ECONOMICS, AND POLITICS* (1995)). Applications of the basic law as product model to wholly new domestic topics continue to appear. For a recent example, see David A. Skeel, Jr., *Rethinking the Line between Corporate Law and Corporate Bankruptcy*, 72 TEX. L. REV. 471 (1994) (suggesting that a variant of state charter competition would be preferable to a federal bankruptcy regime).

²⁷ The volume of applications to general federalism theory has increased notably in the past few years. See, e.g., Weingast, *supra* note 6, at 5-6; Calabresi, *supra* note 8, at 776; LeBoeuf, *supra* note 10, at 556.

²⁸ See, e.g., DAVID L. SHAPIRO, *FEDERALISM: A DIALOGUE* 76-91 (1995).

²⁹ Such as diversity and participation, checks on central concentrations of power, and republican values. See Richard B. Stewart, *Federalism and Rights*, 19 GA. L. REV. 917, 918 (1985) (hereinafter, Stewart II).

After thus becoming a fixture on the landscape of American federalism, regulatory competition expanded to venues world-wide. It has been brought to bear within other federal systems, see Ronald J. Daniels, *Should Provinces Compete? The Case for a Competitive Corporate Law Market*, 36 MCGILL L. J. 130, 150-51 (1991) (Canadian corporate law), and quasi-federal systems, most notably in discussions on strategies for integration within the European Union. See, e.g., Easterbrook, *supra* note 7, at 126-36; Garard Hertig, *Imperfect Mutual Recognition for EC Financial Services*, 14 INT'L REV. L. & ECON. 177, 178 (1994) (applying the Tiebout model to support the point that mutual recognition is superior to national treatment).

It also figures into 'globalization' discussions. Regulatory competition assertions strengthen the case for new supra-national legal regimes that promote free trade. Then they enable a neat *volte face*, prompting caution with respect to all other initiatives for trans-national regulatory cooperation or coordination, while simultaneously supporting arguments for national-level deregulation in response to global competition for investment capital and global product-market competition. See Joel P. Trachtman, *International Regulatory Competition, Externalization and Jurisdiction*, 34 HARV. INT'L L. J. 47, 48-49 (1993).

3. *Restatement as Legal Federalism's Race-to-the-Top*

— Legal federalism uses the Tiebout model to make a general prediction about the evolution of state and local regulation — the ‘race-to-the-top’ view. Two steps are taken. First, state and local governmental actors are assumed to be in intense competition for citizens, factors of production, and capital. Second, the resulting description is assumed to lead to an equilibrium and fitted into a Darwinian evolutionary framework.³⁰ Thus restated, the model promises diverse menus of public goods that meet differing citizen tastes,³¹ and an efficient allocation of industrial activity among junior-level jurisdictions.³² It is predicted that in a dynamic environment, competitive forces should assure that only efficient regulation remains in effect.³³ Over time, then, the standard of all regulation should rise.³⁴ In contrast, centralization and its secondary counterpart of coordination across junior units become the regulatory equivalents of price-fixing³⁵ and presumptively retard the competitive evolution of first-best law.³⁶ The proponent of central government intervention as the solution to a problem must bear the burden of showing why the problem will not be eliminated in due course by market forces.³⁷

³⁰ The race-to-the-top, as a legal paradigm, originated in commentary on US corporate chartering system. Thus viewed, the market for corporate charters assures that efficient legal structures evolve as the states respond to the demands of reincorporating corporate actors. No intervention of the national government is called for. Winter, *supra* note 21, at 290.

³¹ See Weingast, *supra* note 6, at 5.

³² Revesz, *supra* note 10, at 1221-22.

³³ See Trachtman, *supra* note 29, at 65-66. See also Weingast, *supra* note 6, at 5 (arguing that only those regulations for which citizens are willing to pay will survive). Cf. Richard B. Stewart, *Environmental Regulation and International Competitiveness*, 102 YALE L.J. 2039, 2050 (1993) (hereinafter Stewart III) (arguing that trade policy should not be modified for environmental concerns, and that present environmental regulation does not achieve its purposes in a cost-beneficial manner).

³⁴ Although presumably, a jurisdiction will proceed to add to the net regulatory burden of its factors if the political benefits exceed the competitive costs. See Weingast, *supra* note 6, at 6; Maura B. Perry, *A Challenge Postponed: Market 2000 Complacency in Response to Regulatory Competition for International Equity Markets*, 34 VA. J. INT'L L. 701, 706 (1994).

³⁵ Easterbrook, *supra* note 7, at 127.

³⁶ Or at least disrupts it. Revesz, echoing the insights of the tax competition literature, see *infra* text accompanying notes 161-203, points out that preemptive central intervention as to one subject matter need only cause competition to shift to another. Revesz, *supra* note 10, at 1245-47.

³⁷ See, e.g., Been, *supra* note 11, at 511 (local government law); Roberta Romano, *The Genius of American Corporate Law* 19 (1993) (corporate law).

Two universally recognized exceptions to this presumption favoring decentralization should be noted. First, borders must be kept open if factor and citizen mobility is bring competitive discipline to regulation.³⁸ Authority to suppress anticompetitive lawmaking must be vested at higher levels of government, whether through a centralizing device such as the commerce clause of the constitution or a coordinating institution such as the GATT or the NAFTA. Second, externalities must be policed pursuant to economic theory's command that the scope of regulation match the domain of its costs and benefits.³⁹ Competing governments have an incentive to regulate so as to facilitate cross-border cost externalization by their citizens.⁴⁰ The classic example occurs when a jurisdiction makes an exception in its environmental law for a given type of pollution knowing that prevailing winds will blow the permitted particles across the border. Here, not only does the producer externalize a cost, but those affected by the externality have no voice as to its regulation and have not traded its sufferance for higher incomes. With externalities, multiple jurisdictions can even race-to-the-bottom, and either of intervention by a higher level unit or intergovernmental cooperation is justified to remedy the situation.⁴¹

³⁸ Easterbrook, *supra* note 7, at 129.

³⁹ *Id.* at 127.

⁴⁰ If a law is not cost beneficial but involves no externalities there is at least some local incentive to change it; if the costs are externalized, there is no local incentive to make a change. Product liability laws that favor locals are another example of this. Michael Schill, *Uniformity or Diversity: Residential Real Estate Finance Law in the 1990s and the Implications of Changing Financial Markets*, 64 SO. CAL. L. REV. 1261, 1288 (1991).

⁴¹ Stewart III, *supra* note 33, at 2098. The justification for federal intervention does preclude criticism of the regulatory strategy actually implemented. See Richard L. Revesz, *Federalism and Interstate Environmental Externalities*, 144 U. PA. L. REV. 2341 (1996) (arguing that the Clean Air Act does not successfully force internalization of interstate pollution externalities).

In recent years, choice of law behavior in products liability litigation has been argued to present such a case. See Michael E. Solmine, *An Economic and Empirical Analysis of Choice of Law*, 24 GA. L. REV. 49, 54 (1989); Michael W. McConnell, *A Choice-of-Law Approach to Products Liability Reform*, in *NEW DIRECTIONS IN LIABILITY LAW* (W. Olson ed., 1988). McConnell recommends a mandatory federal conflicts rule keyed to the law of the place of the sale. *Id.* Hay argues that the incentive picture is more complicated and counsels caution respecting federalization. Bruce L. Hay, *Conflicts of Law and State Competition in the Product Liability System*, 80 GEO. L. J. 617-18, 651-52 (1992). See also Gary T. Schwartz, *Assessing the Adequacy of State Product Liability Lawmaking*, YALE L. & POL'Y REV./YALE J. REG. SYMPOSIUM ISSUE 359, 365 (1996) (arguing that any problem of state-level structural bias is not as serious as has been suggested); Thomas A. Eaton & Susette M. Talarico, *Testing Two Assumptions About Federalism and Tort Reform*,

A third exception, for welfare and other redistributive policies,⁴² is widely (if not universally)⁴³ acknowledged. Competing local governments have incentives to encourage new investment and immigration by rich citizens and to discourage immigration by poor citizens. It follows that a decentralized system is likely to lead to a lower level of government-mandated wealth redistribution than its citizens otherwise would prefer. Centralized welfare provision (or central intervention to impose minimum welfare standards) thus is indicated.⁴⁴

4. *Ties to Related Devolutionary Theories — Social Choice and Public Choice*

— One sometimes hears jurisdictional competition theory referred to as a branch of public choice theory. This reflects their common rational expectations methodology, common devolutionary recommendations, and common opponents and proponents. But important analytical distinctions between the two need to be recognized. As the discussion that follows shows, jurisdictional competition theory makes a more heroic claim for devolutionary benefits than does public choice theory. The discussion in Parts II and III will go on to show that problems in making good on this claim leave jurisdictional competition in a situation of tension with public choice theory.

YALE L. & POL'Y REV./YALE J. REG. SYMPOSIUM ISSUE 371, 373, 378 (showing that there is no state-level bias). More generally, conflicts rules have been characterized as a part of the juridical fabric of a competitive regime. Trachtman, *supra* note 29.

⁴² See OATES, *supra* note 17, at 6-8.

⁴³ See LeBoeuf, *supra* note 10, at 579, which argues that, given limitations on mobility, local governments will have room to redistribute (even as it argues that regulatory competition otherwise is a useful tool, without any apparent concern for the problem of limitations on mobility).

⁴⁴ See Michael McConnell, *Federalism: Evaluating the Founders' Design*, reviewing RAOUL BERGER, *FEDERALISM: THE FOUNDERS' DESIGN* (1987), 54 U. CHI. L. REV. 1484, 1499-1500 (1987); Stewart II, *supra* note 29, at 919-920, 925-26. See also Clayton P. Gillette, *Equality and Variety in the Delivery of Municipal Services*, 100 HARV. L. REV. 946, 959-61 (1987), reviewing CHARLES M. HAAR AND DANIEL W. FESSLER, *THE WRONG SIDE OF THE TRACKS: REVOLUTIONARY REDISCOVERY OF THE COMMON LAW TRADITION OF FAIRNESS IN THE STRUGGLE AGAINST INEQUALITY* (1986) (pointing out that a disadvantaged class of poor people can be cut out of local interest group politics and arguing that inequality of municipal services favoring the rich may be necessary as a bribe to keep them from moving the suburbs).

An additional point is made. Since here regulation and the attendant politics come down to a determination of cash amount, localized preference diversity presents a less important value. Daniel Shavero, *An Economic and Political Look at Federalism in Taxation*, 90 MICH. L. REV. 895, 965 (1992).

The two theories' common opponent is the public interest theory of government that prevailed in the early post-war era. Public interest theory emphasized government's role as a benevolent maximizer of social welfare both in the provision of traditional public goods and as an economic regulator.⁴⁵ The approach tended to signal centralization as the strategy that best realized the public interest, particularly in the wake of a finding of a market failure. Given a democratic political framework, centralization was not of itself deemed to have dangerous properties. Any expansionary tendencies would be checked as citizens expressed their preferences in the context of interest group competition in the political process.⁴⁶

Public choice proponents countered that the 'public interest' cannot be meaningfully articulated in the first place, much less utilized as a template for regulation. One support for this view came from the theory of social choice, which asserts that the public interest does not emerge in political practice because voting paradoxes prevent the emergence of a preference ordering for public goods, and predicts that no technical adjustment of democratic processes can solve the problem.⁴⁷ Regulation, accordingly, does not embody a 'public interest' in the sense of an aggregation of the preferences of the electorate.

Public choice theory goes on to account for the content of regulation as a reflection of private interests. It asserts that actors rationally employ the government and form groups to influence it. As risk averse lawmakers respond to the dominant voices, lawmaking comes to follow the demand patterns of the

⁴⁵ JEAN-JACQUES LAFFONT AND JEAN TIROLE, *A THEORY OF INCENTIVES IN PROCUREMENT AND REGULATION* 476 (1993).

⁴⁶ The introduction of public choice theory indirectly strengthened this association between the public interest and centralized regulation. Olson's model of government capture stipulates that smaller, better financed interest groups have an advantage when it comes to influencing regulators because they can more easily surmount collective action problems. MANCUR OLSON, *THE LOGIC OF COLLECTIVE ACTION* (1965). This means that producer interests have a structural advantage over interests and policy causes with more diffused bases of support, such as labor, the environment, and, for that matter, free trade. The movement of regulation to higher levels helps to redress the balance, by making possible cost economies in the lobbying efforts of the dispersed interests.

⁴⁷ Voting procedures in theory should aggregate individual preferences into a single consistent preference. Arrow, following earlier theorists, identified a paradox which stated that there is no single, transitive social preference. KENNETH J. ARROW, *SOCIAL CHOICE AND INDIVIDUAL VALUES* (1951); *see also* DONALD P. GREEN AND IAN SCHAPIRO, *FOUNDATIONS OF RATIONAL CHOICE THEORY: A CRITIQUE OF APPLICATIONS IN POLITICAL SCIENCE* 7-8 (1994). *See generally* PETER C. ORDESHOOK, *GAME THEORY AND POLITICAL THEORY: AN INTRODUCTION* 55-56 (1986).

interest groups.⁴⁸ This private rent-seeking activity prompts competition among government actors (who occupy a monopolists' position respecting scarce public goods)⁴⁹ to become rent distributors and receive interest group favors.⁵⁰ Deadweight social losses result.⁵¹

At this point, the Tiebout model, with its competition-based local public goods equilibrium, appears in the picture to offer a theoretical cure.⁵² Since market transactions are the most accurate allocators of resources, government should be structured so that regulation arises not from discussion of the public interest but from the responses of at-the-margin producers. Such a market-driven lawmaking equilibrium also will solve the problem of preference aggregation identified in social choice theory. To achieve it, regulatory authority must be vested in junior level units. Increasing their jurisdiction expands opportunities for competitive lawmaking.⁵³

The Tiebout model's prescription of devolution of regulatory authority to junior levels of government tracks a conclusion reached independently in another line of public choice theory. Under this 'Leviathan' theory of government, government actors, particularly those in central government, use their monopolists' positions to pursue the objective of governmental revenue maxi-

⁴⁸ Producers, in particular, are likely to seek to register demands on lawmakers, looking for subsidies, import quotas, tariffs, price regulation, or government-created barriers to entry, such as licensing requirements. George Stigler, *The Economic Theory of Regulation*, 2 BELL. J. ECON. & MGMT. SCI. 3, 13-17 (1971).

⁴⁹ Gillette, *supra* note 44, at 958-59.

⁵⁰ James M. Buchanan, *Rent-Seeking under External Diseconomies*, in TOWARD A THEORY OF A RENT-SEEKING SOCIETY (James M. Buchanan et al. eds., 1980); R. D. Tollison, *Rent Seeking: A Survey*, 35 KYKLOS 575, 579 (1982).

⁵¹ Under this social choice/public choice diagnosis of the infirmities of democratic government, regulatory capture and excess government growth flourish when discourse about the public interest prevails in lawmaking contexts. The rhetorical equilibrium conceals the determinant rent-seeking. Easterbrook, *supra* note 7, at 128.

⁵² More specifically, Tiebout's analysis was framed as a direct response to Samuelson's conclusion, *see supra* note 14 and accompanying text, that individuals would not reveal their preferences for public goods. The Tiebout model follows from the same behavioral assumptions as does public choice theory and shares its methodological preferences. *See* WILLIAM J. BAUMOL & WALLACE E. OATES, *THE THEORY OF ENVIRONMENTAL POLICY* 288 (2d ed. 1988) (commenting that race-to-the-bottom arguments tend to be informal and yield indeterminate results concerning the effects of competition).

⁵³ The revenue enhancement constraints that prompt competitive responses to citizen (and customer) preferences are likely to be felt with more intensity at junior levels. ROMANO, *supra* note 37, at 48.

mization.⁵⁴ A positive relation obtains between the degree of centralization and the size of government, measured in terms of the budget. Given the uncertainties of majority rule cycling, the rational ignorance of voters, and confusion amongst politicians,⁵⁵ political controls will not be equal to the task of containing government growth. Thus, the provision of public goods will reflect not the utility level of the average taxpayer, but that of the expanding state. Meanwhile, regulatory capture leads to bigger deadweight costs when authority is exercised at higher levels of government.⁵⁶ Decentralization thus is intrinsically beneficial because it reduces the scope of the central government monopoly and ameliorates the negative effects of regulatory capture.

An independent line of public economics also yields a devolutionary presumption, once again repeating the Tiebout model's bottom line. Under this 'decentralization theorem', given a public good consumed by geographical subsets of the population (the production costs of which are equal as between central or local provision), it is always at least as efficient and frequently more efficient for local government to provide a locally determined output level than for central government to provide a uniform level across all jurisdictions.⁵⁷ More generally, decentralization narrows the variance in the distribution of preferences, reduces the likelihood that preferences will be bundled, and ameliorates some problems of asymmetric information. Regulation, thus adapted to local conditions, is more likely to approach the ideal of consonance with citizen preferences.⁵⁸ At the same time, the reduction of the size of the

⁵⁴ GEOFFREY BRENNAN & JAMES M. BUCHANAN, *THE POWER TO TAX: ANALYTICAL FOUNDATIONS OF A FISCAL CONSTITUTION* 17-24 (1980).

⁵⁵ *Id.*; DENNIS C. MUELLER, *PUBLIC CHOICE II: A REVISED EDITION OF PUBLIC CHOICE* 268 (1989).

⁵⁶ Local authorities have less capacity to damage the economy. They cannot impose tariffs and quotas on imports; their licensing arrangements have a limited reach; their limited resources limit subsidies. Incentives to interest groups, accordingly, decrease as authority vests in junior levels. Easterbrook, *supra* note 7, at 127.

⁵⁷ OATES, *supra* note 17, at 35 (1972). Although the point of origin is public economics, the proposition has not been modelled. See ALBERT BRETON, *CENTRALIZATION, DECENTRALIZATION AND INTERGOVERNMENTAL COMPETITION* 185 (1996).

⁵⁸ The larger the number of jurisdictions, the larger the number of winners over the number of losers. See Merrill, *supra* note 7, at 640.

An incidental cost-benefit also is suggested in the literature: Reconciliation of preferences through the political channels of dialogue and voting is costly, and these costs tend to go up with the size of the polity. The larger the group the more heterogeneous and the larger the number of interactions. See ROBERT BISH, *THE POLITICAL ECONOMY OF METROPOLITAN AREAS* 35-37 (1971); Briffault, *supra* note 19, at 402-3.

regulating unit and resulting increase of the number of jurisdictional alternatives⁵⁹ increases the chance that a diverse range of preferences will come to be manifested in regulation promulgated by one or another jurisdiction. The localized experimentation thus fostered⁶⁰ makes possible the appearance of a range of regulatory strategies, while simultaneously limiting the negative impact of unsuccessful experiments.⁶¹

In these combined public choice/public economics stories, then, decentralization leads to two benefits — responsiveness to citizen preferences and product innovation — whether or not it also precipitates an outbreak of competition. The addition of jurisdictional competition theory materially strengthens the case in two ways. First, it predicts a first-best equilibrium given junior-level regulation. This means that not only are preferences statistically more likely to be satisfied at the junior level, as the decentralization theorem asserts, but that they *will* be satisfied on an ongoing basis even given changing conditions. This prediction gives regulatory competition claims a potent role in policy debates. Given a complex cost-benefit comparison of central and junior-level regulatory alternatives, it amounts to a trump card for decentralization. Indeed, it purports to preempt the whole cost-benefit discussion.

Jurisdictional competition theory makes its second contribution as a rebuttal to the argument that devolution simply turns regulatory subject matter over to the distortive manipulations of state and local interest groups. The disciplinary effect of competition across localities and states minimizes losses stemming from these local capture arrangements. Given mobility of people, factors of production, and capital, the imposition of costly and restrictive interest group legislation in one jurisdiction benefits a neighboring jurisdiction with a less costly regime. As the factors vote with their feet, they affect the incentives of lawmakers — inefficient wealth transfers to favored groups become less attractive than regulations that enhance the wealth of the larger population.

⁵⁹ BRETON, *supra* note 57, at 8. Social tastes and preferences differ, and the differences tend to correlate with geography. Calabresi, *supra* note 8, at 775. Smaller units also are more likely to contain populations with majority preferences that depart from majority preference of the population of the larger unit. McConnell, *supra* note 41, at 1498.

⁶⁰ ROMANO, *supra* note 37, at 4-5. *See also* McConnell, *supra* note 44, at 1498.

⁶¹ For a larger governmental unit, small-scale experimentation of this sort is a difficult undertaking. Even the choice of a venue presents a problem. LeBoeuf, *supra* note 10, at 555, 562.

B. The Debate in Legal Federalism: The Race-to-the-Top Versus the Race-to-the-Bottom

The jurisdictional competition paradigm crosses the barrier that separates the public and private spheres to recast the public side in private sector terms. The legal federalism debate over the paradigm focuses on the legitimacy of this move. Opponents answer that competitive government actors will lose sight of their public mission and thereby 'race-to-the-bottom'.⁶²

To see this race-to-the-bottom perspective, consider how a proponent of a public interest approach to regulation would respond to the race-to-the-top story. From a public interest perspective, dismantling federal regulations to encourage junior-level competition amounts to a betrayal of the public trust. With competition, the content of regulation and the level of public goods and taxation are dictated by the private preferences of a narrow, arbitrarily identified class of itinerant at-the-margin consumers, instead of following from a dispassionate and responsible calculation of the public welfare. The individual jurisdiction, forced to cater to their preferences, loses its ability to pursue its notion of the best interests of the citizens committed to remain within it for the long term. At the same time, the disaggregated groups of states and localities lose the technical ability to regulate multistate businesses, with the mere threat of disinvestment sufficing to get firms what they want.⁶³

This race-to-the-bottom picture shares an important point with its race-to-the-top opposite — both assume that government actors are in intense competition for citizens, factors, and capital. But here the race goes downwards because competition forces the pursuit of policies farther and farther removed from the public interest. The characterization invites the remedy of preemptive centralization. If a race must go to the bottom, then the regulatory subject matter should be removed to a higher level of government whether or not competition presently determines the content of regulation at junior levels. This argument is best known as a justification for the federalization of environmental law.⁶⁴

⁶² See generally Peter P. Swire, *The Race to Laxity and the Race to Undesirability: Explaining Failures in the Competition Among Jurisdictions in Environmental Law*, YALE L. & POL'Y REV./YALE J. REG. SYMPOSIUM ISSUE 67, 74-75 (1996) (providing a useful typology of race-to-the-top and race-top-the-bottom argumentation).

⁶³ See Stewart II, *supra* note 29, at 919. Stewart also notes that even assuming that state and local taxes are not the primary factor in firms' locational decisions, states reasonably might worry that taxes might matter at the margin. *Id.* at 949.

⁶⁴ Stewart I, *supra* note 23.

The environmental law literature also contributes a restatement of the race-to-the-bottom position in economic terms. It is said that, without centralization competition for production factors and capital would leave the states in a prisoners' dilemma respecting environmental standards.⁶⁵ Each state would be deterred from promulgating standards at its preferred level of strictness by the threat of a loss of production factors to a defecting competing state. The more intense the competition for factors, the greater the disparity between the level of environmental protection in the public interest and that evolving in practice.⁶⁶

This prisoners' dilemma analysis recently has been rebutted by proponents of jurisdictional competition. The prisoners' dilemma set up, they say, operates on a set of heroic assumptions. It depends on the presence of fixed preferences for strict regulation across many jurisdictions, with each believing that the subject matter should not be one for cost-benefit tradeoffs. Competition for factors and capital and collective action problems then undermine the jurisdictions' ability to adhere to the stated policy, and we end up with a sub-optimal result.⁶⁷ A more realistic set up, say the critics, would depict the situation differently: In a world of scarce resources, cost-benefit tradeoffs between levels of regulation and income are inevitable; no *a priori* fixed preference for a given level of regulation should be assumed. Without fixed preferences across jurisdictions, higher payoffs through cooperation cannot be assumed and a prisoners' dilemma is not inevitable.⁶⁸ While it is in theory

⁶⁵ *Id.*

⁶⁶ Furthermore, given a large number of states, the transaction costs of collective action prevent coordination. The prisoners' dilemma accordingly ripens into a commons dilemma.

For additional applications of this line of thinking, see Alfred C. Aman, Jr., *Administrative Law in a Global Era: Progress, Deregulatory Change, and the Rise of the Administrative Presidency*, 73 CORNELL L. REV. 1101, 1194 (1988); Cass R. Sunstein, *Constitutionalism After the New Deal*, 101 HARV. L. REV. 421, 505 (1985). Revesz restates the prisoners' dilemma account in a two-party framework, showing that where a player has two strategies, lax and strict, a suboptimal lax strategy will strongly dominate the optimal stringent strategy. Revesz, *supra* note 10, at 1216-17, 1229-32. The suboptimal lax strategy is a unique equilibrium and will always be selected. See generally FUDENBERG AND TIROLE, *supra* note 45, at 9-10. In the absence of cooperation or centralization, then, the outcome is Pareto-inferior.

Note also, that given 50 states, co-operation through mutual forbearance is unlikely to evolve even given infinite repetition of the game. Hay, *supra* note 41, at 625-26.

⁶⁷ Revesz, *supra* note 10, at 1219-24.

⁶⁸ LeBoeuf offers a different formulation of the point. He notes that a state that imposes anti-pollution legislation transfers wealth away from industry to those who value a clean

possible that absolute, normatively-based preferences, whether for stricter environmental rules or some other form of regulation, could exist across jurisdictions, this is asserted to be very unlikely as a practical matter.⁶⁹

The race-to-the-top side now has the better of the discussion. The result is that where the race-to-the-top and the race-to-the-bottom once competed for attention as paradigmatic opposites of apparently equal strength, we now tend to see a general presumption in competition's favor.⁷⁰ This result is said to follow from economic theory: Regulatory competition pursuant to the Tiebout

environment. If the redistributive move embodied in the legislation is Kaldor-Hicks superior, then the state can make a second redistributive move (a tax break, for example) that compensates industry for the cost of compliance, and still be ahead on a net basis in the end. If the state does not make the second redistributive move, it presumably prefers the redistributive result of the anti-pollution legislation. If the state enacts no anti-pollution legislation, its residents presumably do not wish to pay the price in terms of lost capital investment. Federal intervention is, accordingly, redistributive. LeBoeuf, *supra* note 10, at 578, 589-90.

⁶⁹ Stewart III, *supra* note 33, at 2058-59. See also Howse & Trebilcock, *supra* note, at 77; Giandomenico Majone, *Market Integration and Regulation: Europe After 1992*, EUR. U. INST. WORKING PAPER 91/10, 23 (1991); Konstantine Gatsios & Paul Seabright, *Regulation in the European Community*, 5 OXFORD REV. ECON. POL. 37, 42-43 (1989). Majone and Gatsios and Seabright both assert that the fact that there could be a prisoners' dilemma at the international level does not of itself provide a sufficient justification for a delegation of regulatory authority to a supra-national level. Meanwhile, a prisoners' dilemma characterization remains structurally appropriate where the motivation for the dominant strategy entails a negative externality. See Hay, *supra* note 41, at 625-26.

⁷⁰ A recent competition-favorable statement from a once-prominent voice on the race-to-the-bottom side, signals the shift. See Stewart III, *supra* note 33, 2079-82. See also Revesz, *supra* note 10. A similar movement can be seen in European commentary. See Majone, *supra* note 69, at 23; Gatsios & Seabright, *supra* note 69, at 37, 42-43.

The degree of acceptance of competition as a regulatory tool can be indirectly confirmed by reference to commentaries that avoid denunciations of competition even as they postulate gains from centralization or coordination. Here centralized regulation instead is advocated as the means to the end of harmonized regulatory standards that bring cost efficiencies. See Stewart III, *supra* note 33, at 2043-44; David Charny, *Competition Among Jurisdictions in Formulating Corporate Law Rules: An American Perspective on the 'Race to the Bottom' in the European Communities*, 32 HARV. INT'L L.J. 423, 426 (1991). National governments even have been seen racing against one another to provide regulation that benefits consumers. Joel R. Paul, *Competitive and Non-Competitive Regulatory Markets: The Regulation of Packaging in the EU*, in INTERNATIONAL REGULATORY COMPETITION AND COORDINATION: PERSPECTIVES ON ECONOMIC REGULATION IN EUROPE AND THE UNITED STATES 353 (William W. Bratton, et al., eds. 1996) (hereinafter INT'L REGULATORY COMPETITION).

framework has survived critical theoretical inspection, while the race-to-the-bottom counter has not.⁷¹

The Figure summarizes the components of the race-to-the-bottom and the race-to-the-top views. It does so for the record only. Succeeding Parts of this Article will show that the new economics of jurisdictional competition supersedes this framework of discussion.

⁷¹ Revesz, *supra* note 10, at 1212.

FIGURE
REGULATORY COMPETITION — THE BINARY ANALYTICAL FRAMEWORK

	Race-to-the-Top	Race-to-the-Bottom
Goal of regulation	<i>Economic welfare</i>	<i>Social welfare</i>
Causality — competition as determinant of regulation	<i>Yes</i> Intense competition determines terms of regulation, given authority at a low level	<i>Yes</i> Intense competition determines terms of regulation, given authority at a low level
Quality of regulation given competition	<i>High</i> Regulation embodies citizen preferences; no prisoners dilemma	<i>Low</i> Capital purchases regulation; prisoners dilemma across jurisdictions
Centralization/ horizontal coordination	<i>Undesirable</i> Rent-seeking causes social costs for the benefit of private interests and impairs free markets cures market failure;	<i>Desirable</i> Holds out cost advantages for influence activities by large groups lacking financial resources; saves costs through harmonization
Decentralization	<i>Desirable</i> Unleashes competition; deters capture; fosters innovation; first best equilibrium evolves	<i>Undesirable</i> Encourages capture by monied interests; encourages market failure
Externalities	<i>Undesirable</i> Justify centralization or cooperation	<i>Undesirable</i> Justify centralization or cooperation
Wealth redistribution	<i>If desired</i> Central function	<i>Desirable</i> Central function

II. THE TIEBOUT MODEL'S EXTRAORDINARY DEMANDS

The Tiebout model's shortcomings are well known to economists. This point has been acknowledged many times in legal scholarship,⁷² sometimes along with a bill of particular theoretical and practical problems.⁷³ Even so, in this

⁷² See e.g., Shavero, *supra* note 44, at 964 (costly exit); Briffault, *supra* note 19, at 427 (externalities and jurisdictional size); Jonathan R. Macey, *Transaction Costs and the Normative Elements of the Public Choice Model: An Application to Constitutional Theory*, 74 VA. L. REV. 471, 506 (1988) (mobility and information costs); Stewart II, *supra* note 29, at 923, 927 (limited mobility); Rice, *supra* note 25, at 54-55 (mobility and number of jurisdictions); Ellickson, *supra* note 19, at 1552 (mobility); Goldberg, *supra* note 20, at 98-108 (optimal size, mobility, externalities).

⁷³ Most of the serious arbitrage exercises occur in these areas of local government and real property law — the subject matter closest to that of public economics. See Been, *supra* note 11; Briffault, *supra* note 19, at 399-403; Gillette, *supra* note 44, at 955-62; Ellickson, *supra* note 19, at 1547-49, 1552; Goldberg, *supra* note 20, at 98-108. The exception is Revesz, *supra* note 10 (environmental law).

These discussions acknowledge that the Tiebout model has encountered difficulties in its home field. But they address themselves in terms only to narrow questions. They thereby avoid confronting the negative implications of the model's sticking points and ultimately they reinforce its robust appearance in legal contexts. Been, *passim*, at 511-39, writes in terms only of land use. But she does a thorough review of the public economics. In endorsing the Tiebout model, she relies on the conclusions of the body of empirical studies. *Id.*, at 51-6-17 & nn. 203-204. We draw a different conclusion. See *infra* notes 147-159 and accompanying text.

Revesz, *passim*, reevaluates the robustness of the Tiebout model in the context of environmental law, making extensive references to public economics literature in so doing. He endorses the Tiebout model, *id.* at 1242-44, but only for the limited purpose of refuting the race-to-the-bottom assertion and asserting that regulatory competition is theoretically consistent with the maximization of social welfare. His evaluation, accordingly, does not address the parallel questions about the race-to-the-top that we ask here: (a) Whether decentralized organization presumptively imports regulation shaped by the operation of competitive forces, and (b) whether competition, once operative, presumptively takes us to a first-best regulatory equilibrium. Oddly, Revesz draws extensively, *id.* at 1238-1246, on a tax competition model that shows that Tiebout-type regulatory competition respecting environmental regulation cannot be expected to result in a first-best equilibrium. See Wallace E. Oates & Robert Schwab, *Economic Competition Among Jurisdictions: Efficiency Enhancing or Distortion Inducing?*, 35 J. POL. ECON. 333 (1988). For our discussion of the implications of this model, see *infra* notes 258-271 and accompanying text.

We also note that interdisciplinary scholars have made cutting-edge contributions to the economics of regulatory competition. See Susan Rose-Ackerman, *Market Models of Local Government: Exit, Voting, and the Land Market*, 6 J. URBAN ECON. 319, 333 (1979); see also Roberta Romano, *Law as Product: Some Pieces of the Incorporation Puzzle*, 1 J.

case the process of intellectual arbitrage from economics to law has been sticky.⁷⁴ Mention of the model's infirmities rarely ripens into acknowledgment of their negative implications for legal federalism's economic presumption in favor of decentralization.⁷⁵ The assumption appears to be that the

L. ECON. & ORG. 225, 233-65 (1985) (empirical study on charter competition). Two outstanding category-specific refutations of regulatory competition arguments also should be mentioned. Hay, *supra* note 41 (refuting in detail claim of race-to-the-bottom in common law of product liability); Sterk, *supra* note 19 (questioning the existence of competitive constraints on land use exactions).

⁷⁴ There has been a failure to retrieve and assimilate past analysis of Tiebout problematics even from within the law reviews. Cautions and *caveats*, once entered, *see, e.g.*, Ellickson, *supra* note 19, 1553, 1554 (commenting that the model 'drastically oversimplifies' the 'elusive reality' of metropolitan organization), are promptly forgotten. As already noted it is well-known within the legal literature, for example, that the Tiebout model cannot be directly applied to the real world because its assumptions never have been successfully relaxed in the subsequent economic literature. It is less well-known that one commentator, Professor (now Judge) Easterbrook, paused to note that the bundle of Tiebout model assumptions can be redeployed as a tool for sorting out legal subject matter ill-suited to application of the model. *See* Easterbrook, *supra* note 24 at 34-35 (fact sensitive standard for distinguishing appropriate from inappropriate subject matter). *See also* Rice, *supra* note 25 at 54-55 (same). The commentary in question has only rarely been cited for that cautionary point, and it has not become the custom to conduct a preliminary suitability evaluation of each topic. Nor does one find suitability standards set out in the existing typologies of regulatory competition situations. *See* Revesz, *supra* note 10, at 1247-53; Trachtman, *supra* note 29, at 59-60. We think that even minimal fidelity to the economics requires that Easterbrook's suitability standard not only re-enter the discourse, but be considerably tightened up in the process.

Given a literature thus constituted, it is unsurprising that clearly erroneous applications of the theory show up. For a definitive rebuttal of one such suggestion, *see* John C. Coffee, Jr., *Competition Versus Consolidation: The Significance of Organizational Structure in Financial and Securities Regulation*, 50 BUS. LAW. 447 (1995) (considering and rejecting regulatory competition as a justification for a proposal circulated in securities law that consolidation of overlapping regulation of derivative and other products by federal banking, commodities, and securities agencies would be a bad idea because the prevailing system implicates beneficial interagency regulatory competition). *Cf.* Henry N. Butler and Jonathan R. Macey, *The Myth of Competition in the Dual Banking System*, 73 CORNELL L. REV. 677, 707-12 (1988) (drawing on public choice theory to refute argument that federal banking agency competes with state agencies for bank incorporations).

⁷⁵ It is not uncommon to mention that serious difficulties attend the model and then proceed immediately to apply it. *See* LeBoeuf, *supra* note 10, at 561; Schill, *supra* note 40, at 1294-96; Easterbrook, *supra* note 24 at 34-35 (arguing that application of the model is appropriate given mobility, a large number of jurisdictions, and no externalities). It also has been reasoned that the existence of a market can be inferred despite imperfections from

model, although problematic as to particulars, retains robustness in its broader outline. This assumption is not safe. The model's robustness has been sharply and successfully contested within its own field, causing it to emerge in a narrower, more tentative form. The terms and implications of this discourse have not been appreciated in the legal literature. We seek to complete this stalled arbitrage exercise in this and the following Part of this Article.

Recall that the Tiebout model depends on a long list of assumptions when it asserts that competitive forces determine the shape of regulation at junior levels of government and sets regulation on an evolutionary path to a first-best equilibrium.⁷⁶ This Part shows what happens to the model when these assumptions undergo relaxation in the ordinary course of testing for robustness. Scrutiny begins with the most important assumption on the Tiebout list — that there exists a large number of communities each of which actively seeks an optimal population — and shows that this assumption conceals an insuperable practical problem and a devastating theoretical problem. The practical problem is that the model envisions a dynamically changing population of political subdivisions that bears not the slightest resemblance to the jurisdictions of the real world. The theoretical problem is that the model yields one of two results when stated formally⁷⁷ — nonequilibrium or unstable equilibrium. It as a result lacks real world predictive value. Additional frictions envelop the model upon relaxation of its assumptions respecting externalities, mobility, information, and entrepreneurial incentives. As these points of friction are acknowledged, the list of exceptions to legal federalism's devolutionary presumption gets so long as to be fatally destabilizing.

The process of scrutiny supports two conclusions. First, the economic theory of federalism should be uncoupled from a general presumption in favor of devolution. This is because junior-level regulation does not necessarily lead to competitively-driven lawmaking, and, even when it does, the competition does not necessarily produce regulation that meets consumer preferences. Second, inspection of the economic model's infirmities highlights opportunities for gain through centralization or coordination. The complexity of the resulting picture implies that a positive theory of jurisdictional competition should evenhandedly address the desirability of both vesting and divesting central or coordinating authority.

the 'possibility of relocation'. Wyeth, *supra* note 8, at 92 n. 10. One exception to all of this is Macey, *supra* note 72 at 507 ('the traditional argument that jurisdictional competition leads to the production of public goods appears to be overstated').

⁷⁶ See *supra* text accompanying note 18.

⁷⁷ Tiebout, *supra* note 13, in fact does not state a formal model.

A. Bundling, Pricing and Optimal Numbers

The Tiebout model's problems begin with the Samuelson condition for efficient of supply of local public goods.⁷⁸ Carried out to its logical conclusion, it requires that individuals sort themselves among different jurisdictions so that homogeneity of demand results in each.⁷⁹ Such individual sorting turns out to be hard to effect. Where private goods tend to be produced and sold separately, public goods tend to be jointly produced and made available on a bundled basis. They are not individually priced. Similarly, regulation tends to apply across the board. Public goods and regulations, then, typically come in complex packages. Furthermore, the complex packages influence the choices of consumers who display greater heterogeneity than those in standard product markets.⁸⁰

⁷⁸ See *supra* text accompanying note 15.

⁷⁹ Assuming that all residents pay equal taxes. A mixed community is said to be *per se* inefficient because public goods provision therein responds to an average of at least two types of demand. See Daniel Rubinfeld, *The Economics of the Local Public Sector*, in 2 HANDBOOK OF PUBLIC ECONOMICS 582 (A.J. Auerbach & M. Feldstein, eds., 1987).

Rubinfeld asks whether the heterogeneity results change if we introduce a Lindahl taxation scheme (defined below) where the tax paid per unit is equal to the marginal benefit from the public good at a given level of provision. But the Tiebout mechanism fails to achieve efficiency here: Even though each type of individual, by moving to a jurisdiction with equal tax, increases her welfare, it makes more sense to redistribute income and not force overconsumption of public goods. *Id.* at 582-83.

Rubinfeld also suggests that this argument can be extended to instances where there are large numbers of individuals who differ in terms of income and tastes. He asserts that given optimal numbers of communities and costless mobility, the tax system will be nondistorting; hence there would be an equilibrium which might be efficient. The difficulties with this scenario lie with the standard list of Tiebout mechanism problematics.

Lindahl was concerned with how to set public spending such that all consumers agree unanimously. He defined government in terms of an auction. When setting tax levels for public goods, the government would offer a tax rate to the consumers who would correspondingly respond with a different shares reflecting their level of spending. New shares are again issued by government (reflecting the preferences of different consumers). The Lindahl process continues until unanimity is reached (a Lindahl price is one which everyone has agreed to). This mechanism has been formalized. See ATKINSON & STIGLITZ, *supra* note 14, at 509-512.

⁸⁰ Susan Rose-Ackerman, *Tiebout Models and the Competitive Ideal: An Essay on the Political Economy of Local Government*, 1 PERSP. ON LOC. PUB. FIN. & PUB. POL'Y 23 (1983). Heterogeneity of preferences occurs not only across populations but within given individuals over time. The citizen who prioritizes school expenditures at one stage of her life later on may prefer expenditures for senior citizens. For this citizen the Tiebout model

The Tiebout model's analytical solution to this problem of complex supply and demand lies in the dissatisfied citizen's move to a community that meets her preferences. So long as the number of jurisdictions is large enough to meet every set of preferences, bundling will not prevent preference satisfaction (given costless mobility and complete information).⁸¹ The problem is that the model achieves this analytical solution by assuming it with its stipulations that each jurisdiction has an optimal size and that a large number of jurisdictions offer a large range of public goods and services.

These two assumptions have a notable interplay. Competition for a large number of public goods presupposes a large number of jurisdictions. Each additional public good raises the number of jurisdictions required. In dynamic conditions, new jurisdictions will have to be frictionlessly formed to meet new demand for particular public goods packages. How many jurisdictions would it take to bring about this first-best result? As the number of public goods becomes very large, the number of jurisdictions must equal the population of individuals.⁸² The analytical result, then, is that optimal competitive governmental structure can be achieved only in an atomistic universe in which the number of jurisdictions matches the number of individuals and firms. Such a universe is a theoretical spontaneous order in which trading markets effect all regulatory adjustments. The advantages of regulatory competition are maximized in this environment: Individual preferences and governmental actions are in identity; diversity is complete; interest group capture of government cannot occur.⁸³ Last, but not least, the bundling problem is solved: In this

implies a move to another community (or requires that the preferences of every member of the citizen's community change simultaneously). [Public Finance and Public Choice] 303.

⁸¹ Note that as the venue moves from the local level to the state and national level, the application of the model becomes less and less plausible. *See, e.g.,* Rice, *supra* note 25 at 54-55.

⁸² *See* MUELLER, *supra* note 55, at 157; *see also* ATKINSON & STIGLITZ, *supra* note 14, at 528-29.

⁸³ Interestingly, if a sufficient number of such jurisdictions were formed to bring us to a first-best world of matched preferences, the idea of interjurisdictional competition would lose much of its force. BRETON, *supra* note 57, at 230. In this world all incoming residents share the preferences of the incumbents; all outgoing residents by definition have non-matching preferences and target a preexisting matching jurisdiction. Although the sorting process may be incomplete, there remains no need for new competitive initiatives from government. Competition need not be involved even in the case of movement into a jurisdiction with a suboptimally low population. That jurisdiction may indeed have an incentive to compete. But, given a reservoir of jurisdictions containing too many residents, it may not need to do so in order to reach optimal size, given complete information and

one-on-one world, public goods in effect are private goods.⁸⁴

Such a spontaneous order, while theoretically attractive to many, is not feasible.⁸⁵ Given different scale economies for different public goods, some minimum jurisdictional size will be implicated in the production of each. Beyond the problem of minimum size⁸⁶ lies the problem of optimal size.⁸⁷

costless mobility. Even if inducements to move have to be offered to residents of the overcrowded jurisdictions, no competitive response by those jurisdictions will follow. *Id.* at 231.

⁸⁴ See Truman F. Bewley, *A Critique of Tiebout's Theory of Local Public Expenditures*, 49 *ECONOMETRICA* 713, 713 (1981).

⁸⁵ Other, less thorough-going cases of spontaneous order can be mentioned. See, e.g., David R. Johnson & David Post, *Law And Borders — The Rise of Law in Cyberspace*, 48 *STAN. L. REV.* 1367, 1391-95 (1996) (suggesting leaving the development of regulation in cyberspace to spontaneous order by analogy to the medieval law merchant). See also Edmund Kitch, *Regulation, the American Common Market and Public Choice*, 6 *HARV. J.L. & PUB. POL'Y* 119 (1982).

⁸⁶ This point has been expressed formally. Stiglitz offers the example of two communities which could be formed with equal number of two types of person except for their preferences. In this model, there are three public goods and two utility functions. If two separate communities are formed, each will produce the preferred public good; however, if the community is merged, the third public good could be produced and as a result individuals will enjoy the benefits of economies of scale. There are, of course, potentially diminishing returns to scale, but Stiglitz argues that in most circumstances people will be better off. Joseph Stiglitz, *Theory of Local Public Goods*, in *THE ECONOMICS OF PUBLIC SERVICES* (Martin Feldstein & Robert Inman, eds., 1977). See also Bewley, *supra* note 84, at 717-18.

⁸⁷ This condition has been described in economic theory: Under the 'theory of clubs' optimal size is a function of the marginal gains that population increases bring to existing residents. See James M. Buchanan, *An Economic Theory of Clubs*, 32 *ECONOMICA* 1, 12 (1965). But, significantly, practical application of this theory brings a confrontation with sticking points that parallel those impairing the Tiebout model — each of externalities and spillovers, heterogeneous citizen preferences, heterogeneous public goods, income discrepancies, and citizen mobility cause problems. *Id.* at 300. Club models and local public goods models should be distinguished. Although club models are concerned with the provision of local public goods, they focus on the pricing of externalities arising from production within a group. Theoretical and empirical work on clubs concentrates on the conditions under which a competitive equilibrium emerges in a club economy. In a club economy it is possible, given a broad assumptions, to generate a competitive (or price-taking) equilibrium. See Suzanne Scotchmer, *Public Goods and the Invisible Hand*, in *MODERN PUBLIC FINANCE* 94 (John Quibley & Eugene Smolensky eds., 1994). In club models the consumer pays a fixed entry cost. In contrast, in local public goods models, assuming taxation of real estate, the entry cost can be adjusted by consuming less land or housing, making it much more difficult to structure a competitive equilibrium. See *infra*

Even if an optimal size could be ascertained as a practical matter, it will be a size so large as to undercut the provision of the large number of jurisdictions Tiebout model requires.⁸⁸ Finally, if we put optimal numbers to one side and look at the real world, we see that both the size and number of jurisdictions will be determined by a path-dependent process of geographical and political evolution. Any jurisdictional competition by means of the Tiebout mechanism, accordingly, can support only second-best efficiency claims.⁸⁹

B. Nonequilibrium and Unstable Equilibrium

1. *The Problem*

— The problem presented by the Tiebout model's assumed optimal numbers can be stated in formal economic terms. These presentations show that from the point of view of economic theory, the Tiebout model's principal shortcoming is its failure to display the properties of a general competitive equilibrium except under an even more restrictive set of assumptions. This shortcoming denudes the model of predictive capacity.

a. *Nonequilibrium*

— Let us relax the Tiebout model's assumption of an infinite number of jurisdictions. That is, the number of types of citizens is greater than the number of available jurisdictions — there are, say, two jurisdictions and three evenly-distributed types of resident. On these numbers, no matter how keenly the two governments compete, it is easy to see that someone always will be dissatisfied and have an incentive to form a new jurisdiction in order to be better off. The result is no equilibrium.⁹⁰

A Tiebout equilibrium has been demonstrated in a model assuming a finite number of jurisdictions, but only given some additional assumptions. This model assumes that there are multiple localities in a finite number, that resident votes determine government policy, and that there are two goods, one public, one private.⁹¹ In addition, there is a continuum of individual types, each of which is ranked according to their marginal rates of substitution between the

text accompanying notes 90-111.

⁸⁸ *Id.* at 302.

⁸⁹ See Daniel L. Rubinfeld, *Comment on Suzanne Scotchmer*, in *MODERN PUBLIC FINANCE* 121 (John Quibley & Eugene Smolensky, eds., 1994).

⁹⁰ See Bewley, *supra* note 84, at 721.

⁹¹ This assures that the residents choice is between more or less public goods, avoiding social problems.

public good and the private good.⁹² The model shows that for any exogenous positive integer M there exists a Nash equilibrium⁹³ with M jurisdictions.⁹⁴ The trick lies in the way the model sets up consumer preferences — they are single-peaked, a very strong assumption. The equilibrium is lost if this assumption is relaxed.⁹⁵

This analysis leaves us with the first of two strenuous requirements for an optimal public goods outcome under jurisdictional competition — consumers must be presented with a range of choices large enough to include the optimal package for each type of consumer.⁹⁶

⁹² Frank Westhoff, *Existence of Equilibria in Economies With a Local Public Good*, 14 J.ECON. THEORY 84 (1977).

⁹³ A Tiebout equilibrium conceivably can be formulated in two different ways: It could be either a Nash equilibrium in which no single individual wishes to join an already existing jurisdiction, or a more demanding equilibrium in which there exists no group of individuals that can make each of its members better off by forming a new jurisdiction. Joseph Greenberg & Shlomo Weber, *Strong Tiebout Equilibrium under Restricted Preferences Domain*, 38 J. ECON. THEORY 101, (1986). Westhoff shows the first, less demanding equilibrium on the assumption of a continuum of individuals. However, the second, more demanding notion of equilibrium presents more difficulties. *Id.*

⁹⁴ See ATKINSON & STIGLITZ, *supra* note 14, at 544-46.

⁹⁵ See Bewley, *supra* note 84, at 727. Nonequilibrium may be the result in cases of myopic majority voting. See Westhoff, *supra* note 92, at 85-90; ATKINSON AND STIGLITZ, *supra* note 14, at 544-46. See also James Buchanan & Charles Goetz, *Efficiency Limits of Fiscal Mobility: An Assessment of the Tiebout Model*, 1 J. PUB. ECON. 25, 28-29 (1972).

Epplé, Filimon, and Romer add that Westhoff, investigating the model's properties, was pessimistic about the prospects for developing a model in which a unique stable equilibrium exists — the model derives a stable equilibrium only when there are multiple equilibria, and a unique equilibrium always will be unstable. Dennis Epplé, Radu Filimon, and Thomas Romer, *Equilibrium Among Local Jurisdictions: Towards an Integrated Treatment of Voting and Residential Choice*, 24 J. PUB. ECON. 281 (1984). Epplé, Filimon and Romer themselves take the position that while the difficulty of relaxing the mobility assumption is fatal to most theorizing about local public goods, a unique public goods equilibrium can exist in limited situations. *Id.* at 283. More specifically, they argue that an equilibrium level of housing can result where consumers select the amount of housing and vote for the level of public goods provision, where there are restrictions on preferences and the technology of the public goods supplied. *Id.* at 307.

⁹⁶ Rubinfeld, *supra* note 89, at 121. See also Susan Rose-Ackerman, *Market Models of Local Government: Exit, Voting and the Land Market*, 6 J. URBAN ECON. 319 (1979); Frank Westhoff, *Policy Inferences from Community Choice Models: A Caution*, 6 J. URBAN ECON. 535 (1979). It could be added that within each homogenous community, the cost per resident of each public good must be the minimum. See Susan Schotchmer & Myrna Holtz Wooders,

b. Unstable equilibrium

— Tiebout's depiction of optimization through the attraction of new residents implies a normative assertion that migration should be encouraged. And, in theory, increases in mobility increase economic welfare by increasing allocative income.⁹⁷ But mobility also entails spillovers with negative implications for economic welfare.

To see this, assume that a number of jurisdictions provide the same public good for two types of resident, one type high income and the other low income. Assume also that demand for the good is income elastic and positively correlated with demand for real property, and that jurisdictions finance production of the good with a flat-rate property tax. The high and low income types thus consume the public good at different marginal rates of substitution. Here is the question: If we proceed to make the assumptions of the Tiebout model, will high and low income types sort themselves into homogenous jurisdictions, yielding a first-best equilibrium?

The answer is no. To see this, assume that such sorting does occur between $t=0$ and $t=1$ so that at $t=1$ all low income types reside in low income jurisdictions and high income types in high income jurisdictions. This equilibrium will be unstable. Between $t=1$ and $t=2$ low income types will have an incentive to migrate to the high income jurisdictions. There they can consume smaller properties, paying lower taxes than the high income types and nonetheless enjoy the same, higher level of public goods. Yet high income types will have no incentive to migrate to low income jurisdictions since they will obtain less public goods with little tax savings.⁹⁸ More generally, given egalitarian access to public goods in each locality and the payment of different levels of real estate tax based on income-based preferences for consumption of real estate, the provision of the public goods will result in wealth redistribution,⁹⁹

Competitive Equilibrium and the Core in Club Economies With Anonymous Crowding, 34 J. PUB. ECON. 159, 162 (1987).

⁹⁷ Factor movements are normally a basis for efficiency gains. PAUL R. KRUGMAN, *RETHINKING INTERNATIONAL TRADE* 20-27 (1990) (hereinafter KRUGMAN I). Krugman, writing in the context of international economics, has demonstrated that labor generally increases its income by moving from one region to another. PAUL R. KRUGMAN, *PEDDLING PROSPERITY* 184 (1994) (hereinafter Krugman II). The gains from this out-migration more than compensate the labor that remains; but payment of such compensation to the labor that remains does not always occur.

⁹⁸ Even if an equilibrium existed, it is likely that there will be high levels of externalities. See Rubinfeld, *supra* note 89, at 123.

⁹⁹ With an income tax, even one without progressive rates, a redistribution still benefits

a result the high income types do not prefer.¹⁰⁰ The built in inducement of low income migration thus makes any equilibrium unstable.¹⁰¹

This spillover problem can be solved if jurisdictions have the discretion to select their residents. Any of number of policy devices can effect such a result. The solution does of course sacrifice the Tiebout model's full mobility assumption. But it does in theory make it possible to derive a stable equilibrium.

A model by Hamilton makes the formal showing.¹⁰² The model assumes, (a) that the housing supply is perfectly elastic; (b) that residents within each jurisdiction have homogenous preferences for public goods; (c) that residents are perfectly mobile; (d) that local governments offer a diverse range of tax and expenditure measures to satisfy all preferences; and, critically, (e) that each jurisdiction has a zoning ordinance requiring each resident to consume a stated quantity of housing, with the stated quantity varying from jurisdiction to jurisdiction. The zoning ordinance builds in a price mechanism. This follows because the ordinance keeps out poor residents who would consume smaller, cheaper houses and thereby gain a surplus of public goods benefits over taxes paid. At the same time, rich residents who desire to consume an amount of housing larger than the jurisdictional minimum will move on to a jurisdiction

poorer residents. To see this, assume a flat income tax of 20 percent. Preferences for the public goods exchanged for the tax will vary depending on the income level of the taxpayer. Presumably, the redistributive effect is a benefit to poorer taxpayers. The opposite could be the case if the jurisdiction imposed a poll tax. Whatever the tax system, open to access to public goods will be redistributive.

¹⁰⁰ Of course, some income redistribution does occur under the auspices of local government. It is possible hypothesize how a modest amount of this could accord with the preferences of high income types. See Kaplow, *supra* note 12, at 472-79.

¹⁰¹ In addition, too much migration to a single target jurisdiction can entail externalities and result in a suboptimal equilibrium characterized by crowding-out. The Tiebout model's other assumptions — that movement by one individual has no effect on the welfare of other individuals, and that, given the presence of public goods, an additional resident benefits the target community — foreclose any possibility of this problem. MUELLER, *supra* note 55, at 157. But neither assumption seems to be plausible as a general proposition.

A converse condition of suboptimality could arise where a locality directs itself to the attraction of new residents through public goods competition. Governments seeking to attract in-migration risk the progressive lowering of taxation to the point at which revenues are unable to finance the public goods package. Stephen Woolcock, *Competition Among Rules in The Single European Market in INT'L REGULATORY COMPETITION*, *supra* note 70. Suboptimal allocations of public goods result.

¹⁰² Bruce W. Hamilton, *Zoning and Property Taxation in a System of Local Governments*, 12 URBAN STUD. 205 (1975).

with a minimum zoning requirement that equals their housing preference. This way they avoid paying higher than average taxes that would confer a public goods benefit on other residents. Thus does the ordinance force each resident to pay an equal share for the jurisdiction's public goods, becoming the functional equivalent of a nondistortionary head tax.¹⁰³

The Hamilton model removes the instability caused by the free movement of residents of different income levels across jurisdictions, and thereby yields an equilibrium. Here citizen mobility leads to an efficient result, because citizens are precluded from adjusting their property consumption level in response to the property tax levels within a given jurisdiction. To adjust, they must move. The problem with model lies in its long and unrealistic set of assumptions.¹⁰⁴ It makes little sense to assume, as the model does, that communities are homogenous both in terms of demand for local public goods and housing, or that there is an exact correlation between housing tastes and income. The model also joins the Tiebout model in demanding a number of communities large enough to match the tastes of all individuals for both housing and public goods consumption.¹⁰⁵ Finally, and just as critically, the model tolerates no political bias favoring old residents over newcomers. Such a bias, often present in the real world, leads to strategic zoning and tax appraisal regimes designed to force newcomers to pay a greater than pro rata share of public goods cost, destroying the equilibrium.¹⁰⁶

In sum, there emerges a second strenuous condition for a public goods equilib-

¹⁰³ See also Bruce W. Hamilton, *Capitalization of Intra-Jurisdictional Differences in Local Tax Prices*, 66 AMER. ECON. REV. 743 (1976) (showing that average costs will equal marginal costs in this system).

¹⁰⁴ This equilibrium result, moreover, clarifies the regressive implications of Tiebout preference satisfaction for community life. If one tries to hypothesize a Tiebout-Hamilton world, the first thing that comes to mind is the contemporary private, gated, and fenced community.

¹⁰⁵ The last requirement means that profit-maximizing entrepreneurs must be free to produce new communities to satisfy the demands of the residents. In addition, the public good must be produced at minimum average cost with respect to population. See Rubinfeld, *supra* note 79, at 591.

¹⁰⁶ See M. J. White, *Fiscal Zoning in Fragmented Metropolitan Areas*, in FISCAL ZONING AND LAND USE CONTROLS 97 (E.S. Mills & Wallace E. Oates, eds., 1975) (asserting widespread strategic zoning disrupts the Hamilton equilibrium and leads to suboptimal public goods provision). See also Susan Rose-Ackerman, *Beyond Tiebout: Modelling the Political Economy of Local Government in LOCAL PROVISION OF PUBLIC SERVICES: THE TIEBOUT MODEL AFTER TWENTY-FIVE YEARS* (G.R. Zodrow, ed. 1983).

rium. In addition to an optimal number of jurisdictions, the provision of public goods in each must be tied to a strict membership criterion. If we now take a look at the real world, we see that no equilibrium can be expected. The numbers fall short of the optimum. And even if the numbers did not fall short, any equilibrium would be unstable. The public sector (at least as we have known it in American history) is institutionally unequipped to replicate the gate-keeping of a private club. Unsurprisingly, many economists have concluded that the Tiebout mechanism succeeds in cases so stylized as to lack realism.¹⁰⁷

2. Implications

— The Tiebout mechanism having failed to yield a stable equilibrium in theory, a question arises as to its viability as a practical policy tool. The question is serious as a matter of economic theory. In economics the study of efficiency presupposes a stable institutional framework. As a result, questions respecting stability take precedence over questions respecting efficiency.¹⁰⁸

We will put it bluntly — the Tiebout model, viewed in isolation, provides no basis for predicting that competitive behavior on the part of government leads to preference matching. The prediction instead is this: Competition may make residents better off or worse off depending on a dynamic and complex mix of factors that competing governments cannot control. With this result, economic theory literally withdraws its support from an unqualified presumption in favor of devolution. This does not go to say that a powerful economic case cannot be made for a devolutionary initiative. But such a case will require a much more complex foundation than that offered by the Tiebout model.

Let us hypothesize what functions a minimalist central government would have to perform in a competitive federal system, given the Tiebout model's shortcomings. Certainly, the central government must monitor junior level competition and be prepared to intervene to import stability. This regulatory function

¹⁰⁷ JEAN-JACQUES LAFFONT, *FUNDAMENTALS OF PUBLIC ECONOMICS* 57 (1988). At best, he says, Tiebout's approach would decrease the heterogeneity of populations living in the same locality, but ultimately leave us to figure out how other motives — workplace, natural advantages, exogeneity of sites — determine the location of agents. *Id.* See also Rubinfeld, *supra* note 79, at 589, 591; Bewley, *supra* note 84, at 713-14; P. Pestieau, *The Optimality Limits of the Tiebout Model*, in *THE POLITICAL ECONOMY OF FISCAL FEDERALISM* (Wallace Oates, ed. 1977).

¹⁰⁸ BRETON, *supra* note 57, at 240-41.

in part would parallel that played in the private sector by an antitrust authority.¹⁰⁹ But, as the wider literature of Tiebout imperfections is taken into account, it becomes clear that additional stabilizing tasks would have to be undertaken. The central government would have to address tax and other fiscal externalities, infrastructure development, research and development, wealth redistribution, and local government structure.¹¹⁰

The last factor, local government structure, opens a Pandora's Box of junior level public choice problems and associated failures in the market for regulation. That list of failures can be expected to be lengthy. To see this, return now to the problem with which this Part began — that of bundled public goods and heterogeneous consumer preferences. The model's failure to yield an equilibrium except on stylized assumptions tells us that this problem cannot be solved. The law as product analogy becomes attenuated as a result. Competition respecting public goods turns out to present a level of complexity respecting supply and demand that far outstrips anything we see respecting ordinary goods and services. This does not prevent such competition from occurring; but it does make it less likely that consumer preferences will have a disciplining effect on producers in any given case.¹¹¹ As the expected disciplinary effect diminishes, the Tiebout model fails of its essential purpose as a preference matching device and public choice problems return to center stage.

¹⁰⁹ That is, it would prevent predatory pricing, conspiracies and cartels, and trade barriers. *Id.* at 250-51.

¹¹⁰ *Id.* at 251-62.

¹¹¹ Many public economists find Tiebout's location model to be an unsatisfactory solution to the problem of ascertaining individuals' preferences respecting public goods. See Dieter Helm & Stephen Smith, *The Decentralized State: The Economic Borders of Local Government*, in *ECONOMIC BORDERS OF THE STATE* (Dieter Helm ed., 1989); G.A. Hughes, *Rates, Reform and the Housing Market*, in *THE REFORM OF LOCAL GOVERNMENT FINANCE IN BRITAIN* (S.J. Bailey & R. Paddison eds., 1987).

C. Frictions Inhibiting the Tiebout Mechanism: Mobility, Information, and Externalities

1. Externalities and Spillovers

— Legal federalism concedes the necessity of relaxing Tiebout's assumption of an absence of externalities and accepts a limit on decentralization for the policing of externalities.¹¹² The externalities mentioned most often in the literature are the physical ones that give rise to tort liability. But the economic concept of externality encompasses a much broader universe of behavioral effects. In the theoretical first-best regime of public goods production, all costs and benefits are restricted to the providing jurisdiction.¹¹³ Any departure from this first-best implicates an externality. Real world practice at the state and local level falls sort of the first-best in limitless ways. Taxes can fall differentially on out of state owners.¹¹⁴ Alternatively, actions of one jurisdiction can benefit other jurisdictions, requiring adjustment by a central authority.¹¹⁵ More broadly, where markets are incomplete and information is

¹¹² The same relaxation ultimately must follow for spillovers, which are positive externalities. Restating the point, in order to bring about internalization, larger and larger jurisdictions are required, reducing the menu of choices. *See* Briffault, *supra* note 19, at 427.

¹¹³ *See infra* text accompanying note 18. This point has been expanded into a simple theory for locating the level of government appropriate for any particular regulatory problem — the geographical area affected by the regulation should determine the level of government. *See* James M. Buchanan & Gordon Tullock, *THE CALCULUS OF CONSENT: LOGICAL FOUNDATIONS OF CONSTITUTIONAL GOVERNMENT* 113-16 (1962). For an application of this point to environmental regulation, *see* Henry N. Butler & Jonathan R. Macey, *Externalities and the Matching Principle: The Case for Reallocating Environmental Regulatory Authority*, *YALE L. & POL'Y REV./YALE J. REG. SYMPOSIUM ISSUE* 23, 25 (1996).

¹¹⁴ *See* notes 147-159 and accompanying text *infra*.

¹¹⁵ In product markets, externalities can occur when the calculus of a given consumer has an impact on the future choices of other consumers. Sometimes the value of a product is tied to the number of purchasing consumers. The utility of telephones increases with the number of users; with computers, increased use brings can increased selection of technically compatible goods; with many other machines, increased use can mean scale economies in spare parts manufacture and a larger supply of experienced repair personnel. Such products exhibit 'network externalities': Existing users benefit from a positive externality when a future consumer opts for the product and increases the size of the network; the externality becomes negative when another consumer terminates use. Joseph Farrell & Garth Saloner, *Installed Base and Compatibility: Innovation, Product Preannouncements, and Predation*, 76 *AMER. ECON. REV.* 940 (1986).

These spillover effects among consumers mean that one consumer's private calculus

imperfect — as tends to occur in the world outside of the constrained models of neoclassical welfare economics — actions by one individual often can have externality-like effects on the interests of other individuals which the acting individual fails to take into account.¹¹⁶ Adverse selection and moral hazard problems are well-known examples.¹¹⁷ In all such circumstances, free market transactions will not be Pareto efficient and, in theory, intervention by a higher authority can be unambiguously welfare improving.¹¹⁸

We have already seen that the costless mobility assumed in the Tiebout model has the potential to cause externalities, thus broadly defined. If different levels of income preponderate in different localities, a policy looking to competitive matching of public goods packages and individual preferences can have unintended effects of wealth redistribution, can result in overcrowding, or can disrupt fiscal policy.¹¹⁹ We will see in Part III that public economics has developed an extensive literature on fiscal externalities incident to state and

has no necessary relationship to an optimal result. When network externalities influence supply and demand, decentralized, individually-maximizing decisions will be path dependent. *See, e.g.,* Philip H. Dybvig & Chester S. Spatt, *Adoption Externalities as Public Goods*, 20 J. PUB. ECON. 231 (1983); Michael Katz & Carl Shapiro, *Systems Competition and Network Effects*, 8 J. ECON. PERSP. 93 (1994); Michael Katz and Carl Shapiro, *Technology Adoption in the Presence of Network Externalities*, 94 J. POL. ECON. 822 (1986). Suboptimal equilibria may result — there may be excessive uniformity among products or excessive diversity, or an inferior product may come to dominate the market. *See* Paul A. David, *Clio and the Economics of QWERTY*, 75 AMER. ECON. REV. 332 (1985); for a counterstory, *see* S. J. Liebowitz & Stephen E. Margolis, *The Fable of the Keys*, 33 J. L. & ECON. 1 (1990). The simple picture of product competition that informs the Tiebout model, in contrast, assumes that value-behavior by consumers leads directly to optimality. This assumption is not safe to the extent that the choices of consumers of law have significant network effects. In the latter case, junior level diversity may be more of a cost than a benefit. Michael Klausner makes a case for applying models of network externalities to legal technologies. *See* Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757 (1995). *See also* Charny, *supra* note 70. For a general argument against employment of the network models in legal contexts, *see* Michael I. Krauss, *Regulation vs. Markets in the Development of Standards*, 3 SO. CAL. INTERDIS'Y L.J. 781, 797-808 (1994).

¹¹⁶ *See* JOSEPH E. STIGLITZ, WHITHER SOCIALISM? 28-29 (1994).

¹¹⁷ *Id.* at 30-31. Margaret Brinig & F.H. Buckley, *The Market for Deadbeats*, 25 J. LEG. STUD. 201, 206, 224-27 (1996), shows empirically that some states have legal regimes that attract migrant deadbeat debtors, assisting them in frustrating their out-of-state creditors.

¹¹⁸ STIGLITZ, *supra* note 116, at 27-32.

¹¹⁹ *See supra* notes 132-159 and accompanying text.

local taxation.¹²⁰ Significantly, this literature employs a modified version of the Tiebout mechanism to show that downward competition to externalize presents a significant problem at the state and local level.

The point for present purposes is this: Externalities hold open a larger door for appropriate regulatory intervention by central government than the legal federalism literature assumes. A question arises as to the plausibility of a theory of government built on global devolutionary presumption *ex ante* subject to adjustment for externalities by a central authority acting *ex post*, much like a caretaker. If the property gets damaged, the *ex post* adjustment may be too little, too late.

2. Mobility

— The Tiebout model's assumption of full mobility, like its assumption of no externalities, is implausible. Movement, after all, is costly. But if jurisdictional competition is to be widespread in practice this assumption can be relaxed only slightly. Mobility breaks the monopoly on regulation held by the actor's jurisdiction of origin and makes possible the choice of regulatory regimes.¹²¹ It therefore must be immediately feasible for jurisdictional competition to occur in practice.¹²²

In Tiebout's model, individuals are the mobile factors of production. But significant transaction costs attend individual changes of domicile, even where abundant employment opportunities exist across jurisdictional lines. These costs will vary from move to move depending on both the distance and the condition of local housing markets. The cost thus relates directly to the geographical size of the home and target jurisdictions. The larger the community,¹²³ the more

¹²⁰ See *infra* notes 161-203 and accompanying text.

¹²¹ This assumes that significant choices are held out. The literature tends to ignore one possible sticking point. Most models assume two-tier of government, central and local. In our system, however, there tend to be three, federal, state, and local. The fact that a particular county's public goods offerings are first-best to a particular consumer may not induce a move if the resident dislikes the state in which the county is located. See BRETON, *supra* note 57, 191-92.

¹²² Although Tieboutian sorting depends on actual movement, it should be noted that governments can feel competitive pressure without actual movement occurring. By analogy to the critical influence of the potential entrant on the behavior of the monopolist, threatened exit can motivate reform with actual exit signalling unwillingness to compete. BRETON, *supra* note 57, at 237.

¹²³ The mobility assumption, accordingly, becomes more and more of a sticking point

it costs to leave it, and the less the mobility possessed by its citizens.¹²⁴

With individual mobility, pecuniary barriers may not be the most significant element in the larger cost picture. Family, community, and cultural ties also can make movement an undesirable response to dissatisfaction with public goods, taxes, or regulation. At some level, then, the localism that jurisdictional competition theory seeks to promote retards the mobility that it presupposes.¹²⁵ Finally, even among localities, the potential scope of competitive discipline always will be limited by the immobility of land — local governments remain free to some extent to usurp land rents.¹²⁶

3. *Information*

— The Tiebout model assumes perfect information about the characteristics of all public goods in all jurisdictions. This assumption, like those of no externalities and full mobility, must be relaxed. Unfortunately, relaxation makes it technically impossible for the model to realize on its claims.

Like much of law and economics, jurisdictional competition theory asserts that, assuming an appropriate initial allocation of wealth, every Pareto-efficient allocation can be attained through the use of market mechanisms. The mathematics that undergird this result stress the importance of convex indifference curves. That is, market-driven Pareto efficiency depends on the assumption that the law of diminishing returns and diminishing marginal rates of substitution ordinarily obtain. With sufficient nonconvexities, in contrast, markets will not be competitive.¹²⁷ It is now understood that wherever information is imperfect, nonconvexities will be pervasive. Information is a fixed cost that must be incurred regardless of the use eventually made of it. The return on a little piece of information thus is always zero, and to the extent that investment in that little piece of information is costly, a net loss always results. Such

as the model's venue of application moves from the local level to the state and national level. Rice, *supra* note 25, at 54-55.

¹²⁴ MUELLER, *supra* note 14, at 155. Contrariwise, the smaller the community, the more likely it is that benefits accruing from the provision of a specific public good will spill over into other communities, causing externalities across communities and non-Pareto allocations.

¹²⁵ Contrariwise, large numbers of local governments and high mobility lessen both the significance and likelihood of participation in local government processes. Briffault, *supra* note 19, at 407.

¹²⁶ See Sterk, *supra* note 19, at 844-45, 850, 857-58; Macey, *supra* note 72, at 506-7.

¹²⁷ STIGLITZ, *supra* note 116, at 45, 55-56. It was thought that consumers and producers normally would satisfy the assumption of convexity. *Id.* at 56.

fixed costs in information give rise to nonconvexities, and, in theory, can justify intervention by governmental authority.¹²⁸

Economists assert that several conventional assumptions about the convexity of private goods cannot be extended to markets for local public goods.¹²⁹ To restate this point, clearing prices for public goods usually cannot be shown. It is, accordingly, unsafe to assume that public goods are competitively priced. This implies, in turn, that markets for public goods (to the extent they exist) will be sticky.¹³⁰

This point can be restated less technically. If relocating persons have imperfect information about the range of alternatives (and investment in the acquisition of perfect information is not cost-beneficial), then they cannot match their preferences with the best-suited locality, and a first-best equilibrium does not emerge from the local government free market.¹³¹ To the extent that actors are aware of the bounds on their information sets, they will tend to assign their preference orderings respecting jurisdictions in accordance with factors other than public goods and regulation. Contrariwise, if citizens proceed to move on a basis of limited information and uninformed regulatory competition results, then the mismatch between preferences and public goods may be greater in magnitude than that existing *ex ante*.

¹²⁸ STIGLITZ, *supra* note 116, at 52-54.

¹²⁹ LAFFONT, *supra* note 107, at 60-76; ATKINSON & STIGLITZ, *supra* note 14, at 520.

¹³⁰ Like the externality problem, the information problem could be ameliorated through central government intervention. Here the device would be investment in a central information-sorting repository (and mandatory disclosure of any nonpublic information). But, unlike the case of externalities, controversy would follow the suggestion of central intervention. Compare ROMANO, *supra* note 37, at 91-108 (suggesting that due to market incentives to disclose participation in the securities mandatory disclosure system be optional), with FRANK H. EASTERBROOK AND DANIEL R. FISCHER, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 290-291 (1991) (suggesting that mandatory disclosure is justified because incidental benefits to third parties stemming from disclosure create systematic incentive to under-disclose).

¹³¹ A recent study shows that voters in a metropolitan area frequently lack information about tax and service alternatives. See David Lowery & William E. Lyons, *The Impact of Jurisdictional Boundaries: An Individual Level Test of the Tiebout Model*, 51 J. POL. ECON. 73 (1989).

D. The Problem of Entrepreneurial Incentives

1. *The Entrepreneurial State and the Problems of Observation and Verification*

— The Tiebout model's prime mover is that cost-minimizing producer of public goods, the local public goods entrepreneur. The model does not in terms assume the existence of this key actor, and, analytically, it need not do so. Entrepreneurship respecting public goods is instead the logical outcome of the operation of the model's mechanism of consumer choice.¹³² In the model's vision of things, local government actors must act entrepreneurially or lose their entire populations. Obviously, however, to the extent the model's assumptions cannot be relaxed, and this competition does not appear in practice, local officials will not be forced to an entrepreneurial behavior pattern.

Might maverick entrepreneurs appear to jump-start the competitive process? Consider the possibility of a local government takeover tycoon who shows up to apply the model by turning real world frictions into an arbitrage profit. The scenario is simple. First the actor identifies jurisdictions with high cost, inefficiently produced public goods. Then the actor buys real estate in the most inefficient such jurisdiction. Next the actor invests in getting elected to office, and once in office cuts production costs drastically. Finally, the actor sells the previously purchased real estate and collects an arbitrage profit. This actor has a high powered incentive to invest in information acquisition, and, like a stock market arbitrageur, ameliorates the real world problems of asymmetric information. Given extreme levels of inefficient goods production, even product bundling should present no problem. Efficient management, taken alone, should cause taxes to come down and real estate prices to go up, securing the arbitrage profit.

But a problem remains. A second assumption lies concealed within the Tiebout model's complete information assumption — an assumption that the quantity and quality of local public goods are both observable and verifiable by both residents and potential residents. As to some local public goods this will be the case — the public swimming pool, school buildings, streets, and fire trucks are there for all to see. But concrete, asphalt, and steel are unlikely to influ-

¹³² When combined with the assumption that local public goods are verifiable information. See Caroline M. Hoxby, *Is There an Equity-Efficiency Trade-Off in School Finance? Tiebout and A Theory of the Local Public Goods Producer*, NATIONAL BUREAU OF ECONOMIC RESEARCH WORKING PAPER 5265, September 1995 at 5.

ence the marginal consumer of local public goods. School quality matters more, but is much harder to specify. Consumer verification thus becomes a serious problem. Here hard statistical evidences, such as student teacher ratios, training records, even college board scores, are crude. Valuations, then, cannot be extracted for the critical public goods. As a result, the conditions necessary for an entrepreneurial arbitrage model do not emerge. Non-verifiability, then, provides one explanation of why we do not see cost reductive entrepreneurship respecting local public goods.¹³³

There result serious doubts about a core proposition of the Tiebout model — that communities with populations below the optimal size will compete for new residents. The model, deeming this proposition to be safe, depicts government as a rent-seeking black box¹³⁴ and side-steps the problematic exercise of describing supply-side incentives in the public goods market.¹³⁵ This approach is implausible. The problem of verifiability, taken together with the other frictions that retard the operation of the Tiebout mechanism, looms so large as to make it unsafe to assume that interjurisdictional rivalry for citizens is ever so intense as to obviate the need for a particular description of supply-side incentives.

2. *The Conventional State as Entrepreneur*

— The Tiebout model's supply-side problem comes more sharply into view upon an informal comparison of incentive profiles of private sector entrepreneurs and local government actors. Both actors produce for pecuniary and other personal gain. The private sector actors must do so competitively due to the presence of other private sector actors selling the same goods or services and the diminished returns and risk of bankruptcy that come from excess production costs and high prices or low sales. When government actors produce public goods and regulation, in contrast, the consequences of management failure are less catastrophic, diluting the incentive effect. These actors produce for votes or other political capital. If they fail to compete their jurisdiction does not disappear, unlike an economically uncompetitive the

¹³³ Hoxby, *supra* note 132, at 7.

¹³⁴ Cf. Alan Schwartz and Robert E. Scott, *The Political Economy of Private Legislatures*, 143 U. PA. L. REV. 595, 596 (1995) (criticizing 'black box' treatment of regulatory output of private legislatures such as the American Law Institute).

¹³⁵ Of course, new residents can lead to scale economies. But that does not complete the incentive story — the scale economies must be tied to the political or economic interests of the lawmakers.

firm.¹³⁶ Fiscal improvidence can, of course, lead to bankruptcy for a government unit. But, unlike the case of a firm, an absence of product competitiveness would seem to be neither a necessary nor a sufficient cause. Generally, then, with government, agency problems in the production of public goods can be presumed to be more substantial than those within firms. Here self-interested production does not necessarily imply product entrepreneurship.

Public economists have attempted to ameliorate this problem by restating the assumption respecting supply-side motivations. For example, in some models property value maximization replaces population maximization.¹³⁷ This approach resonates better. But it solves the problem of supply-side incentives only if we make the further, implausible assumption of identity between the jurisdiction's government actors and its real estate interests. Other models analogize to private sector profits and assume that government desires to maximize taxes collected.¹³⁸ Here again the change yields a more plausible model, for government actors do need operating revenues.¹³⁹ But an entrepreneurial state still does not emerge. Questions come up about the intensity of the revenue constraint, its connection to particular outcomes, and the role of competition in shaping those outcomes.¹⁴⁰ Indeed, given Epplé and Zelenitz's

¹³⁶ Revesz, *supra* note 10, at 1233-35.

¹³⁷ See, e.g., Jon Sonstelie & Paul Portnoy, *Profit Maximizing Communities and the Theory of Local Public Expenditures*, 5 J. URBAN ECON. 263 (1977).

¹³⁸ See *infra* notes 147-154 and accompanying text.

¹³⁹ A conceptual antecedent is noted in Dennis Epplé & Allan Zelenitz, *The Implications of Competition Among Jurisdictions: Does Tiebout Need Politics?*, 89 J. POL. ECON. 1197-1217 (1981). That model made one of the key contributions to the move away from the Tiebout mechanism, arguing that long run individual sorting into communities will not ameliorate the problem of fiscal rent extraction. They assume an exogenous number of communities, inflexible community boundaries, and inactive landowners and developers. The role of politics is introduced by virtue of the fact that local government, given passive owners and residents, will attempt to maximize its tax revenues by usurping maximal land rents. The Gordon models add interest group politics to the tax revenue maximization assumption. *But cf.* J. Vernon Henderson, *The Tiebout Model: Bring Back the Entrepreneurs*, 93 J. POL. ECON. 248 (1985) (calling this Tiebout with bad politics).

A related line of literature should be distinguished. This is the line of public choice theory that shows that bureaucrats are able, through agenda control, to expand public goods output beyond the level preferred by the median voter. See, e.g., WILLIAM A. NISKANEN, *BUREAUCRACY AND REPRESENTATIVE GOVERNMENT* (1971). In those models tax revenue maximization implies overproduction of public goods. In the tax competition models, it is just as likely that underproduction of local public goods results.

¹⁴⁰ It also would seem safe to project a variable relationship between this revenue incentive and the incentive to expand expected voter consent. See BRETON, *supra* note 57,

famous formal showing that citizen mobility cannot completely eliminate government monopoly power,¹⁴¹ a tax maximization incentive invites a perverse result.

In sum, an entrepreneurial state cannot be assumed.¹⁴² As a result, the Tiebout model fails to achieve incentive compatibility.¹⁴³ Under what economists call the theory of the second-best, the Tiebout model's black box must be opened so that the problem of motivating government actors to supply public goods in accord with citizen interests can be addressed directly. Such an exercise has two critical implications. First, it entails rejection of the claim that the Tiebout mechanism solves the problem of regulatory capture. Second, it invites the substitution of complex incentive picture in which market competition shares a place with the conventional political factors of interest group influence and voter accountability.¹⁴⁴

There results a very different, more complex working model of competitive

at 237.

¹⁴¹ Eppler & Zelenitz, *supra* note 139, at 1199.

¹⁴² Perhaps it may be created in the future under a different set of institutional arrangements. See *infra* text accompanying notes 204-225.

Even where incentives to compete clearly are present, additional incentive problems may inhibit the evolution of first-best legal products. With the network models, described above, we saw that a demand-side problem can cause suboptimal equilibria to evolve and product innovation to be choked off in situations of intense product competition. Supply-side problems also may come up. Product innovation presupposes an incentive to invest in research and development. With industrial competitors, prospects of a patent monopoly bolster the incentive. The patent deters entry by competitors, assuring a potential return on investment in research and development. The basic patent model assumes that there is an optimal way to stimulate firms to invest in research and development, which is deemed to be necessary for product innovation. See Michael Spence, *Investment Strategy and Growth in a New Market*, 10 BELL J. ECON. 1 (1979). Conversely, if an innovation easily can be copied by a rival, then new technologies will not efficiently replace old technologies. Legal innovation leads to the production of a public good, and carries no patent protection. Ian Ayres, applying this point to corporate law, suggests that competing states will have insufficient incentives to invest the resources in product innovation. Ian Ayres, *Supply Side Inefficiencies and Competitive Federalism*, in INT'L REGULATORY COMPETITION, *supra* note 70, at 239.

¹⁴³ Paul Seabright, *Accountability and Decentralization in Government: An Incomplete Contracts Model*, 40 EUR.ECON. REV. 61, 63 (1996).

¹⁴⁴ This has of course been suggested many times in the law review literature. For a recent instances, see Swire, *supra* note 62, at 94; Daniel C. Esty, *Revitalizing Environmental Federalism*, 95 MICH. L. REV. 570, 638-51.

government. In this model government actors act entrepreneurially when the tax revenues, export earnings, jobs, technology, or other positive externalities yielded by the attraction of residents, factors of production, or capital also happen to yield appropriate political benefits, either in the form of electoral advantage or satisfaction of the demands of favored interest groups.¹⁴⁵ Part III of this Article shows that it is just these elements distinguish some new formal models of jurisdictional competition.

E. Empirical Tests of the Tiebout Mechanism

How, given the Tiebout model's nonequilibrium and unstable equilibrium results and its long list of disabling frictions, can we explain the legal literature's ongoing endorsement of its predictive power? One explanation lies in a thick stack of studies of its testable implications. These have been said to provide strong support for the core proposition that jurisdictions use packages of taxes and public goods to compete for residents,¹⁴⁶ apparently thereby overcoming the model's sticking points.

We have two comments about this body of empirical work. First, the characterization of its results as strong support is itself too strong. We show below that the results at best are suggestive and make very little progress toward an affirmative showing of a crucial missing element — entrepreneurial behavior patterns on the part of government actors. Second, even if the studies did offer strong support for the Tiebout model's assertion that jurisdictions compete with public goods and tax packages, that support would not compensate for the model's failure to yield stable equilibrium results. The model makes two primary assertions, one descriptive and the other normative. The studies are for the most part directed to the descriptive assertion that jurisdictions compete for residents. The normative assertion, which the studies do not address, is that

¹⁴⁵ Or, in the alternative, the particular factor cuts an advantageous deal with the responsible government actors directly. We would add a factor — the satisfaction incident to enhancing public welfare.

It is less certain that an entrepreneurial incentive relationship can be assumed as a systematic proposition. Indeed, where it does exist it can be ephemeral. Unlike firms, which must hew to the profit incentive over time, the objectives of government suppliers change over time with voter preferences. *See* Rose-Ackerman, *supra* note 73, at 329. Of course, under a loose Tieboutian view of the world, sorting through migration brings homogeneity and thus political stability. But in Rose-Ackerman's formal attempt to model this, the opposite result occurs: Migration causes the identity of the median voter to change, resulting in an unstable equilibrium. *Id.*

¹⁴⁶ Been, *supra* note 11, at 517, 527-8.

this rivalrous behavior will lead to a first-best result of matching between public goods packages and citizen preferences. It is this assertion that is undercut by model's failure to yield a stable equilibrium.

1. Capitalization Studies

— On the surface, one line of empirical work on the Tiebout mechanism does provide support for its normative assertion. This line began with Wallace Oates' famous study showing that tax and public goods levels are capitalized in property values. More particularly, property values are negatively related to property tax levels and positively related to education expenditures.¹⁴⁷ This result, which has been confirmed many times,¹⁴⁸ supports the model's descriptive story by confirming demand-side awareness of the contents of tax and public goods packages. And it appears to do even more. Oates suggested that consumers can use real estate prices as guides to the jurisdictions with the best public goods provision — high real estate values imply a surplus value of public goods benefits over the tax cost.¹⁴⁹ In this view, house prices both measure the amount which relocating citizens are willing to pay for public goods and measure the differential attractiveness of communities.¹⁵⁰ Thus conceived they seem to bear a familial resemblance to prices on the New York Stock Exchange. Perhaps, then, the real estate market provides an empirical equilibrating market for local public goods, along with a market discipline mechanism for government actors.

Unfortunately, the analogy to the securities markets is infirm. To the extent that house prices capitalize the public goods package and confirm consumer awareness, they simultaneously negate the existence of a Tiebout equilibrium. Since the consumers of real estate treat local taxes as the price they pay for public goods, no capitalization could occur in a world with a Tiebout equilib-

¹⁴⁷ Wallace Oates, *The Effects of Property Taxes and Local Public Spending on Property Values: An Empirical Study of Tax Capitalization and the Tiebout Hypothesis*, 77 J. POL. ECON. 957, 966-7 (1969).

¹⁴⁸ The literature has been summarized. See Keith Dowding, Peter John & Stephen Biggs, *Tiebout: A Survey of the Empirical Literature*, 31 URBAN STUD. 767, 775-779 (1994); see also Been, *supra* note 11, at 521-23; According to Dowding, *et al.*, *passim*, at 776, the numbers yielded as to the quantum of capitalization vary widely across the literature. Estimates vary between zero and 100 percent, with most results fixing capitalization at between 30 and 70 percent. In addition, a several methodological shortcomings have been uncovered and corrected as the literature has developed. *Id.* at 775-6.

¹⁴⁹ Oates, *supra* note 147, at 968.

¹⁵⁰ BRETON, *supra* note 57, at 238-39.

rium. This is because, in equilibrium, marginal demand equals marginal cost. In a public goods equilibrium, then, the value of public goods benefits exactly equals the taxes levied to produce them. Given that equality of benefit and cost, there will be no excess value or dead weight cost to be capitalized in real estate prices.¹⁵¹ Oates, then, inadvertently confirmed the absence rather than the presence of a Tiebout equilibrium!¹⁵²

The real world's failure to deliver optimal numbers explains the result. Presumably, if there were a sufficiently large number of communities and public goods packages from which to choose, no rational citizen would be willing to pay a premium over the intrinsic value of the public goods on offer in any particular jurisdiction. She would move instead to a jurisdiction that matched her preferences. In contrast, the combination of a limited number of communities, a high demand for public goods, and taxes set at the cost of public goods provision, implies that the aggregated jurisdictions fail to satisfy demand. As a result, real estate prices go up as the value of the benefit is capitalized¹⁵³

¹⁵¹ Matthew Edel & Elliot Sclar, *Taxes, Spending and Property Values: Supply Adjustment in a Tiebout-Oates Model*, 82 J. POL. ECON. 941, 946-47 (1974).

¹⁵² Dennis Epple, Allan Zelenitz & Michael Visscher, *A Search for Testable Implications of the Tiebout Hypothesis*, 86 J. POL. ECON. 405, 406 (1978).

The Hamilton modification of the Tiebout model, *see supra* text accompanying notes 102-106, also refutes the suggestion that real estate values serve as a price mechanism in a local public goods market. Recall that the model reaches a stable equilibrium result by stipulating a zoning regulation that functions as a nondistortionary head tax. In so doing it concretely demonstrates that the Tiebout model's central problem is the *lack* of a price mechanism. Dowding, *et al.*, *supra* note 148, at 778.

Epple & Zelenitz, *supra* note 139, at 1212-13, revives the Oates claim, asserting that statistically significant estimates of capitalization evidence the presence of a Tiebout mechanism. BRETON, *supra* note 57, at 238, objects to this reading. Citing Dennis Epple, Allan Zelenitz & Michael Visscher, *passim*, Breton notes that they assume an equilibrium and that nothing can be surmised about an equilibrium's properties from an equilibrium analysis of disequilibrium states. On the other hand, notes Breton, given a scarcity of desirable locations, it hardly is surprising to see results indicating capitalization of higher rental values.

¹⁵³ Edel & Sclar, *supra* note 151, at 942. Edel and Sclar's study utilizes data on house prices and finance in Boston over a period of two decades. They conclude that there was movement towards equilibrium in respect of education provision over the period, but constant capitalization of highway expenditures. George Richard Meadows, *Taxes, Spending and Property Values: A Comment and Further Results*, 84 J. POL. ECON. 869, 878, 879 (1976), criticizes Edel and Sclar's methodology and reruns Oates' New Jersey numbers to show some movement toward equilibrium during the period of the study.

(or go down if the tax burden exceeds the value of the public goods returned).¹⁵⁴

2. *Other Studies*

— An additional body of Tiebout studies focuses exclusively on demand-side motivations, attempting to measure the extent to which tax and public goods considerations influence migration. Here aggregate census data has provided a basis for showings that fiscal factors are statistically significant influences on population movement. To summarize the principal results, first, no groups of migrants are attracted by high tax rates; second, migrants who are people of color are sensitive to levels of welfare provision; and, third, results are mixed on the question whether white migrants are sensitive to levels of welfare provision.¹⁵⁵ There is a methodological problem with these studies, however. Since they use census data to measure individual motivations, they remain open to the introduction of additional variables. Micro-level studies of relocation motivations — conducted through questionnaires — solve this problem but suffer from a cheap talk possibility.¹⁵⁶ The micro-level studies reach sharply conflicting conclusions in any event, with one side asserting that tax/public goods packages are relatively uninfluential, and the other side asserting that they matter.¹⁵⁷

¹⁵⁴ The Tiebout equilibrium view showed up in the tax policy literature long after the appearance of the refutation centered on capitalization. Given a Tiebout equilibrium and benefits equalling public goods, there is no basis in tax policy for allowing a deduction for local real estate taxes. See 1 U.S. DEPT. OF TREASURY, TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH 63 (1984); THE PRESIDENT'S TAX PROPOSALS TO THE CONGRESS FOR FAIRNESS, GROWTH AND SIMPLICITY 63 (1984); Charles R. Hulten & Robert M. Schwab, *A Haig-Simons-Tiebout Comprehensive Income Tax*, 44 NAT'L TAX J. 67 (1991).

For an exposition of the tax policy implications and relative merits of the equilibrium and capitalization views, see Louis Kaplow, *supra* note 12, at 420-57. Kaplow has some skepticism respecting claims that perfect capitalization occurs in the real world, although he does expect a long run capitalization effect. *Id.* at 447-8.

¹⁵⁵ We rely here on the collection and recounting of the literature in Dowding, *et al.*, *supra* note 148, at 779-82.

¹⁵⁶ *Id.* at 784-5.

¹⁵⁷ Compare David Lowery & William E. Lyons, *The Impact of Jurisdictional Boundaries: An Individual Level Test of the Tiebout Model*, 51 J. POL. 73 (1989) (studying Louisville area and concluding that tax/service is unimportant), with Stephen L. Percy & Brett W. Hawkins, *Further Tests of Individual-Level Propositions from the Tiebout Model*, 54 J. POL. 1149 (1992) (studying metropolitan Milwaukee and concluding that housing values matter most and tax/service packages figure in as a secondary factor with crime and schools).

Yet another body of studies shows that people tend to sort themselves out by location, causing populations in particular jurisdictions to tend toward homogeneity. This result is consistent with the Tiebout hypothesis and supports an inference that the sorting occurs due to tax/public goods package preferences. The problem with these studies is that, statistically speaking, if there is a large number of jurisdictions and random (as opposed to intentional) sorting, a relatively more homogeneous subset will emerge anyway.¹⁵⁸

These studies, taken together with the capitalization studies, do support the idea that people pay attention to tax/public goods packages. But they thereby only take us one step past the general assertion that citizens have preferences respecting taxes and public goods. The assertion that sorely needs empirical confirmation is the supply-side point that local government actors actively compete for residents with tax/public goods packages. The assertion receives only indirect support here. To the extent that mobile residents respond to fiscal variables, it follows that governments will be sensitive to mobility. An inference of rivalrous behavior arises.¹⁵⁹ But the behavior pattern's strength and character remains a matter of conjecture. As we have seen, a long list of real world frictions stands between the behavior pattern and the projection of a

Other studies that go beyond aggregate data to micro-level data on household choices open up a distinction between the fiscal influences on choice to move and on the choice of a destination once the decision to move has been made. Results conflict. Compare William F. Fox, Henry W. Herzog & Alan M. Schbottman, *Metropolitan Fiscal Structure and Migration*, 29 J. REGIONAL SCI. 523 (1989) (finding that fiscal factors tend to influence the decision to leave), with Brian J. Cushing, *The Effect of the Social Welfare System on Metropolitan Migration in the US by Income Group, Gender and Family Structure* 30 URBAN STUD. 325 (1993) (finding that AFDC payment levels do influence departure decisions of low-income persons, but do influence choice of destination with high AFDC payments attracting low-income households and repelling non-poor female households). For a summary of micro-level work, see Dowding, *et al.*, *passim*, at 782-7.

¹⁵⁸ Dowding, *et al.*, *supra* note 148, at 774. There also are some equivocal results in the stack of studies. See Robert M. Stein, *Tiebout's Sorting Hypothesis*, 23 URBAN AFFAIRS Q. 140, 155 (1987) (testing Tiebout by regressing service/tax package differentiation against mean municipal heterogeneity and finding no significant relationship other than racial sorting).

A final body of studies, more directly connected to the Leviathan assertion of public choice theory than to the regulatory competition literature, shows that big government tends to cost more per capita, and smaller government tends to cost less. The problem with this stack is that it measures expenditures but not efficiency. They can mean either that smaller units provide the same public goods packages for less or that demand tends to drop where jurisdictions are small. See Dowding, *et al.*, *passim*, at 769-71.

¹⁵⁹ BRETON, *supra* note 57, at 239.

concrete regulatory result. There remains every reason for skepticism about policy presumptions that rely on competitive behavior.

III. JURISDICTIONAL COMPETITION IN A SECOND-BEST WORLD: THE NEW APPROACH

The development of a robust version of the Tiebout model stood high on the public economics agenda for more than a quarter century. But lately the field has moved on to other topics, without ever having reached that goal. Although continued pursuit a workable, self-standing Tiebout mechanism has fallen off the agenda, jurisdictional competition still figures prominently in research in the field. These work, which we term the 'new approach', models jurisdictional competition in a second-best framework. It continues to employ the Tiebout mechanism, but only for limited purposes or in substantially modified form. It also pursues alternative conceptions of competitively disciplined local public goods production. Meanwhile, it leaves the first-best Tiebout model on the sidelines, there to stand as a compelling vision of an unattainable state of the world.¹⁶⁰

One line of research, the tax competition literature, employs a modified version of the Tiebout mechanism to model the problem of externalities in a federal system. These models employ a capacious concept of externality that includes, first, all fiscal cost and benefit consequences of public goods production that cross state lines, and, second, all intrastate economic and political distortions. They tell a cautionary story about distortive effects that can be expected when junior levels of government compete in a federal system. They insist that, given competition, productive public goods provision must include the delineation and correction of these externalities. The problem cannot be assumed away, as in the Tiebout model, or brushed off to one side as a limiting factor, as in legal contexts. Confronting the problem, meanwhile, implies central government intervention.

A second line of literature concentrates on local level information asymmetries and pursues the same question formerly pursued through Tiebout modelling — the design of local government mechanisms that cause preferences and

¹⁶⁰ As we have seen, *see supra* notes 78-159 and accompanying text, given a fixed number of geographically-defined jurisdictions, efficiency claims must take the status of second-best. With fixed boundaries, a unique equilibrium respecting public goods production is unlikely to emerge. Rubinfeld, *supra* note 89, at 124.

public goods production to be matched. Some of these models employ the Tiebout mechanism, acknowledging its shortcomings and supplementing it with additional preference matching mechanisms. Other models abandon the Tiebout mechanism altogether. Instead of using competition as an outside force that solves political problems by avoiding them, these models address the democratic process and look at ways to make it more competitive.

Taken as a whole, the new approach withdraws economic theory's support for the legal literature's general presumption that competitive forces assure that devolution enhances welfare. To survey this literature is learn that legal federalism has yet learn how to ask the right questions about the economic welfare effects of devolution.

A. Tax Competition Models

In a first-best economy, taxation and public goods provision meet the Samuelson condition¹⁶¹ — that is, the sum of each person's willingness to pay for another unit of a public good for her marginal benefit equals the cost of producing that additional unit.¹⁶² For that to be the case, all costs and benefits must be restricted to the providing jurisdiction. As we have seen, models in the Tiebout mold signal an easy route to that result by stipulating exclusive use of a residential head tax.¹⁶³ With a head tax, there can be no interjurisdictional tax spillovers, and, given the further assumptions of perfect mobility and an unlimited supply of states, no state can be positioned to export its tax burden.¹⁶⁴ Given all of this, it follows¹⁶⁵ that interstate tax competition should be encouraged — it enhances welfare by forcing state governments to lower tax rates, constrains the self-serving activities of politicians, and limits efficiency losses they otherwise can cause.¹⁶⁶

¹⁶¹ See *supra* text accompanying note 16.

¹⁶² John Douglas Wilson, *Capital Mobility and Environmental Standards: Is There a Theoretical Basis for a Race to the Bottom?* in FAIR TRADE AND HARMONIZATION: PRE-REQUISITES FOR FREE TRADE? VOLUME I: ECONOMIC ANALYSIS 393, 397 (Jagdish Bhagwati & Robert E. Hudec, eds. 1996).

¹⁶³ See *supra* notes 102-107 and accompanying text.

¹⁶⁴ Robert P. Inman & Daniel L. Rubinfeld, *Designing Tax Policy in Federalist Economies: An Overview*, 60 J. PUB. ECON. 307, 315 (1996). The formal showing is in the Hamilton model, discussed *supra* text accompanying notes 102-106.

¹⁶⁵ Reference to the Leviathan school of public choice theory provides affirmative support for this assertion. See *supra* notes 54-56 and accompanying text.

¹⁶⁶ See, e.g., Charles E. McLure, *Tax Competition: Is What's Good for the Private Goose Also Good for the Public Gander?* 39 NAT'L TAX J. 341 (1986) (arguing that rational

The new generation of tax competition models no longer employs this first-best template, however. Like the Tiebout model, they assume that state governments compete, although here tax dollars rather than citizens are the sought-after commodity. These models also presuppose mobile citizens and capital and mobile consumption across state borders. But they situate the Tiebout mechanism in a world of myopic government actors and predict the results of government cost-benefit decisions respecting public goods provision that fail to consider secondary effects, whether internal or external to the taxing state.¹⁶⁷ The prediction is economic distortion, a problem that can be aggregated when governments compete for factors or capital. The models suggest a range of policy remedies.

1. Basic Model

— The basic model comes from Gordon.¹⁶⁸ It assumes a two-tier federal structure in which residents reside in one state and sell their factor inputs and purchase goods and services throughout the federation. State governments hire factor inputs to produce goods and services and meet their revenue needs by taxing factors and goods and services. Social welfare is defined as an aggregate of (a) the social welfare function for all types of people across the states, (b) after-tax prices for goods, services and factors, (c) public goods provision, and (d) a state-by-state congestion factor tied to prevailing price levels. Taxes may be residence-based or source-based — that is, they are either based on the residence of the taxpayer or based on the sources of transactions, whether the place of employment or the point of purchase of goods and services. Each state sets its own tax rate, constrained by a requirement that it balance its budget. In addition, the state government must satisfy the reelection demands of local citizens — the model specifies a political objective function sensitive to the political power wielded by groups in state politics.¹⁶⁹ The maximization of the political objective function determines the state's tax rates, subject to the

jurisdictions should be prepared to reduce taxes on capital until the revenue yielded balances the costs of public goods production).

¹⁶⁷ Suzanne Scotchmer, *Public Goods and the Invisible Hand*, in MODERN PUBLIC FINANCE, *supra* note 87, at 115.

¹⁶⁸ Roger H. Gordon, *An Optimal Taxation Approach to Fiscal Federalism*, 95 Q. J. ECON. 567 (1983). See also John Douglas Wilson, *Optimal Property Taxation in the Presence of Inter-Regional Capital Mobility*, 18 J. REGIONAL ECON. 73 (1985).

¹⁶⁹ Gordon, *supra* note 168, at 577. Gordon models the simple case of median voter politics across all states. See also Walter Hettich & Stanley L. Winer, *Economic and Political Functions of Tax Structure*, 78 AMER. ECON. REV. 701 (1988), expanding the model to encompass coalition politics.

budget constraint. As with the Tiebout model, households and factors are mobile across jurisdictions. Finally, each state government is assumed to be myopic¹⁷⁰ respecting the allocative effects of its tax rates on tax rates in other states and on relocation decisions of citizens.¹⁷¹

The model shows that where an island jurisdiction could set an optimal tax rate, interstate effects prevent a state in a federation from so doing, leading to suboptimally low provision of public goods.¹⁷² Five types of distortive effects are described — tax exportation, regressivity, ‘not-in-my-backyard’ (or ‘NIMBY’) tax devices, tax spillovers, and ‘beggar-thy-neighbor’ tax competition.

The first effect, tax exportation, occurs when tax burdens and resulting public goods benefits are distributed unequally. In one case the effect is interstate — taxes paid by out-of-state citizens and firms pay for public goods consumed in-state. The other case is intrastate — the controlling voting coalition within the state enjoys most of the public goods benefits while sharing the taxation burden with disenfranchised local citizens (as well as non-residents). In either case, officials will have an incentive to overuse the exportative tax.¹⁷³ The second distortion is the system’s bias toward regressive results. Given factor mobility, exit or threatened exit by upper income households will tend to keep the tax burdens and public goods benefits evenly balanced. Welfare provision for the poor thus is blocked.¹⁷⁴ The third problem con-

¹⁷⁰ Gordon, *supra* note 168, at 577.

¹⁷¹ Equilibria have been demonstrated for competitive federalist economies thus modelled. See Ravi Kanbur & Michael Keen, *Jeux Sans Frontieres: Tax Competition and Tax Coordination When Countries Differ in Size*, 83 AMER. ECON. REV. 877 (1993); Jack Mintz & Henry Tulkens, *Commodity Tax Competition between Member States of a Federation: Equilibrium and Efficiency*, 29 J. PUB. ECON. 133 (1986).

¹⁷² See also David Wildasin, *Some Rudimentary ‘Doupolity’ Theory*, 21 REGIONAL SCI. & URBAN ECON. 393 (1991), showing the relationship between the ability of a jurisdiction to export taxes and market constraints. This treatment assumes that a highly elastic supply of capital makes it difficult for jurisdictions to export the costs of public goods to non-resident owners, resulting in a distorting impact on the tax structure and underexpenditure for local public goods.

¹⁷³ Inman & Rubinfeld, *supra* note 164, at 316 argues that this effect is most likely to be significant with taxes on consumption. Mobility will make the effect less substantial with taxes on capital and labor. *Id.* See Leslie E. Papke, *Interstate Business Tax Differential and New Firm Location: Evidence from Panel Data*, 45 J. PUB. ECON. 47, 67 (1991) (capital taxation induces capital mobility).

¹⁷⁴ For documentation of this effect, see Gilbert E. Metcalf, *Tax Exporting, Federal Deductibility, and State Structure*, 12 J. POLICY ANAL. & MGT. 109, 124 (1993).

cerns congestion. Myopic states can raise tax rates to encourage exit by unwanted businesses and residents, causing remaining residents to be better off. This NIMBY phenomenon is particularly likely to show up respecting noxious production processes that are in the aggregate socially beneficial.¹⁷⁵ The fourth distortion follows from indirect effects of increases or decreases in tax rates. One variety of indirect effect concerns the taxing state's fiscal policy and occurs on an intrastate basis. A change in tax rates will alter private sector consumption levels, causing an indirect tax revenue effect; similarly, tax rate changes will affect the prices of factors, and the cost of running state government will rise or fall as an indirect result. The second category of indirect effect is the cross-border spillover. Given mobility, consumption and factors may migrate elsewhere when a state raises its tax rates. This can mean positive effects in other states — tax revenues in the target states go up and the cost of public sector inputs goes down.¹⁷⁶ The upshot for the home state is a disincentive to use a tax applicable to a mobile tax base,¹⁷⁷ even though such a tax entails transaction cost efficiencies.¹⁷⁸ Fifth, and finally, come effects on the terms of trade on offer in the home state. Price changes following upon tax rate changes have an impact on the incomes of local residents.¹⁷⁹ As a result, there will be an incentive to provide for low taxes on mobile inputs so as to increase income returns to the members of the state's dominant coalition. When more than one state seeks to attract such mobile inputs, there results the 'beggar-thy-neighbor' effect characteristic of the classic race-to-the-bottom.¹⁸⁰ As might be expected, subsequent models in the litera-

¹⁷⁵ Inman & Rubinfeld, *supra* note 164, at 314, 317.

¹⁷⁶ An extensive literature on capital taxation explicates this effect. See Roger H. Gordon, *Can Capital Income Taxes Survive in Open Economies*, 47 J. FIN. 1159, 1160 (1992); David Wildasin, *Interjurisdictional Capital Mobility: Fiscal Externality and a Corrective Subsidy*, 25 J. URBAN ECON. 193 (1989).

¹⁷⁷ Inman & Rubinfeld, *supra* note 164, at 315.

¹⁷⁸ In models allowing for only one type of tax, these spillovers will cause an incentive to underprovide local public goods. See George R. Zodrow & Peter Mieszkowski, *Pigou, Tiebout, Property Taxation and the Underprovision of Local Public Goods*, 19 J. URBAN ECON. 356 (1986).

¹⁷⁹ Aggregate income changes to the income of private firms are assumed to be zero both before and after any rate change. Inman & Rubinfeld, *supra* note 164, at 312.

¹⁸⁰ See *supra* note 63. The Oates-Schwab model of an environmental race-to-the-bottom, see Oates & Schwab, *supra* note 73, is the classic example.

According to Inman and Rubinfeld, *supra* note 164, at 317, tax spillovers and terms of trade effects are unlikely to be significant respecting consumption taxes. Factor taxes are a different matter, however. Here there is significant empirical support for significant effects. See R. Wassmer, *The Use and Abuse of Economic Development Incentives in a*

ture focus in particular on interstate competition for scarce capital, and yield similar results.¹⁸¹

At the bottom line, these tax competition models signal that interjurisdictional coordination must be employed to bring the states into a Pareto superior equilibrium.¹⁸² In the alternative, corrective central government intervention

Metropolitan Area; 46 PROC. NAT'L TAX ASS'N 146 (1993) (showing extensive use of tax subsidies); John Mutti, William Morgan & Mark Partridge, *The Incidence of Regional Taxes in a General Equilibrium Framework*, 39 J. PUB. ECON. 83 (1989) (computable general equilibrium model showing that a 1 percent increase in a region's tax on business capital leads to a significant out migration of regional capital and results in significant out of state revenue effects); William Morgan, John Mutti & Mark Partridge, *A Regional General Equilibrium Model of the United States: Tax Effects on Factor Movements and regional Production*, 71 REV. ECON. & STATISTICS 626, 631 (1989) (computable general equilibrium model showing that regions can increase residents' income by substituting a lump sum tax for existing taxes on mobile labor).

¹⁸¹ Zodorow & Mieszkowski, *supra* note 178, develops a model in which jurisdictions compete for capital investment by holding down a source based tax to finance local public goods. See also Roger H. Gordon, *Taxation of Investment and Savings in a World Economy*, 76 AMER. ECON. REV. 1086 (1986) (arguing that when other tax instruments are available, a local government of the Zodorow-Mieszkowski type will make use of resident based taxation in lieu of source based taxation). For a contrasting vision, see John Douglas Wilson, *A Theory of Inter-Regional Tax Competition*, 19 J. URBAN ECON. 296 (1986), in which an individual jurisdiction relies on a property tax which is distortionary and may restrict the public good level because of the perceived marginal excess of the local tax. In Wilson's model, there are many small jurisdictions, each relying on a uniform tax rate and facing an exogenously given net return to capital. A fixed supply of capital in the overall economy is assumed. Given tax competition, there will be underprovision of local public goods if all households would be better off by a simultaneous increase in the amount of public goods in all jurisdictions. Wilson shows that tax competition will lead to a prisoners' dilemma, as taxes are driven too low as the state tries to capture flows of mobile capital. A PD obtains because each symmetric community understands an increase in local tax spending to cause a loss of local capital. See also S. Bucovetsky & John Douglas Wilson, *Tax Competition with Two Tax instruments*, 21 REGIONAL SCI. & URBAN ECON. 333 (1991) (arguing that when both residence and source based taxation are available, local governments provide efficient levels of local public goods).

¹⁸² See J. Edwards & Michael Keen, *Tax Competition and Leviathan*, 40 EUR. ECON. REV. 113 (1996) (arguing that international tax coordination is required when the tax on mobile capital is the only revenue source available to policy makers; and suggesting that when policy makers are neither wholly benevolent nor wholly unconcerned about the welfare of citizens, it is clear that, irrespective of whether the tax base is fully or partially mobile, a small multilateral increase in the tax on mobile capital from the non-cooperative equilibrium will increase the welfare of the representative citizens). See also Guy Gilberd & Pierre

may be justified. Significantly, the literature tends avoid suggesting broad-brush centralization and looks instead to discrete interventions. The central government might, for example, lay down the rules of the game, requiring that all state taxes be resident-based, as opposed to source-based, with a consequent diminution in incentives to externalize.¹⁸³ In the alternative, state-level distortions might be corrected with strategically directed central taxes that would be tied to corrective grant-in-aid reallocations.¹⁸⁴ Finally, given source-based

Picard, *Incentives and Optimal Size of Local Jurisdictions*, 40 EUR. ECON. REV. 19 (1996) (showing that optimal size of a jurisdiction in respect of public good production relates to the magnitude of uncertainty on cost and spillover effects).

Coordination tends to be viewed as a superior alternative to centralization because it keeps authority at junior levels. But coordination is not easily sustained on a spontaneous basis — a central authority will have to design a reward and punishment system in order to induce cooperation. Peter Klibanoff & Jonathan Morduch, *Decentralization, Externalities, and Efficiency*, 62 REV. ECON. STUD. 223 (1995), show formally that the cost of inducement may exceed the benefit of coordination. In this model, 'coordination will be worthwhile only if external effects are at least as large as the largest possible private net benefit'. *Id.* at 234.

¹⁸³ Inman & Rubinfeld, *supra* note 164, at 318-19. Administration would present a problem, however, since each jurisdiction would have to keep track of its residents' out-of-state transactions. In addition, local tax regressivity would remain unconstrained. Wage and income taxes piggy-backed on a centrally administered tax regime are suggested. Consumption taxes would present more of a problem due the possibilities for unobservable out-of-state activity. *Id.* at 319.

A restriction to residence-based taxation would reduce interstate tax exportation but leave in place the possibility of intrastate exportation across political coalitions. Inman and Rubinfeld argue that it also would deter NIMBY competition on the theory that the activity to be discouraged through a tax disincentive now by definition is owned by a resident; to the extent nonresidents conduct such activity they could not be taxed. Other competition would be discouraged 'since mobile capital ... is uniformly taxed across locations under the residency principle'. *Id.* at 319.

¹⁸⁴ *Id.* at 320-21. For example, in order to combat beggar-thy-neighbor tax breaks on investment capital, the central government could tax the benefitted factor or good at its source and redistribute the proceeds in a 'locationally neutral' fashion. *Id.* at 321. See also David Wildasin, *Interjurisdictional Capital Mobility: Fiscal Externality and A Corrective Subsidy*, 25 J. URBAN ECON. 193 (1989) (employing a Nash equilibrium approach with immobile agents, viewing tax competition as an externality, and constructing a corrective subsidy).

Inman and Rubinfeld acknowledge a substantial feasibility problem: The economic incentives that lead to inefficiency at the state level may lead toward inefficient central government correctives. They look to strong national political parties and executive power as counterweights to the inefficient tendencies of legislative logrolling, and as a final backstop, they suggest that a restriction to resident-based taxation be embedded in the

taxation across jurisdictions of unequal size, a minimum tax rate may have a beneficial effect. It has been shown that the asymmetrically sized states will find their way to a noncooperative equilibrium in which the small state sets a lower tax rate than the large state, resulting in a higher level of tax revenue and spending in the smaller state.¹⁸⁵

2. Evaluation

— This theoretical case for interstate coordination or central intervention becomes a practical case only to the extent that these models describe economic distortions of significance in the real world.¹⁸⁶ We think that a marginally

constitution. Inman & Rubinfeld, *supra* note 164, at 328-29.

¹⁸⁵ Kanbur & Keen, *supra* note 182. The Kanbur-Keen model shows that the inefficiency problem that would exist if the states were of equal size becomes aggravated in when the sizes are unequal. The analysis is unusual in that it focuses on the role of size of jurisdiction as a source of inefficiency in itself and invites application to a range of issues, such as location decisions of multinationals or transfer pricing policies among affiliates.

In the Kanbur and Keen analysis, the model consists of two states. Taxes are based on source and enforcement is imperfect. Each citizen can either purchase a unit of commodity in her own state where it is available for t or can travel to the bordering jurisdiction where it can be purchased for T , incurring travel and other transaction costs. The consumer will purchase the unit in the next jurisdiction only if the surplus she enjoys exceeds that from buying the unit locally and the surplus is nonnegative. With the borders are open between states, the question concerns how to choose the best tax rate to maximize revenue, given that each country will taken into account the tax rate of the other. *Id.* at 879-80.

Asymmetry emerges between the responses of the small versus large state. We start at $t=0$ with low tax rates in both states and open the borders. Given the low rate, it is optimal for the home state to set its tax above the outside rate, given that at the margin it is not worth attempting to attract home certain citizens. As the rate increases, the optimal response is for the home state to increase its rate. In terms of rate of increase, the best response to increase the rate exactly half. But, this rate is subject to change when the increase of tax is sufficiently high, that the best response is to increase the tax rate by a discontinuous reduction. *Id.* at 881.

The model suggests two significant strategic responses. First, the increase in cross-border shopping provides a basis for the large state to increase taxes without loss of revenue to the small state. For this reason, the small state is able to increase its own tax rate without fear of lost trade to the neighbor state. The upshot is that if strategic responses are taken into account, it will be apparent that an increase in transport costs will have little impact on the cross-border shopping. It follows that it is also not too risky for the lower tax state to induce measures which makes it more costly to cross-border shop.

¹⁸⁶ The view of those responsible for these models is that they are. See Inman & Rubinfeld, *supra* note 164, at 316-18, 322 and sources cited in notes 168-171 *supra*.

stronger claim for plausibility can be for this literature than can be made for precedent applications of Tiebout mechanism. This conclusion follows from consideration the tax models' success in confronting problems left unsolved in the antecedent Tiebout literature the matters of unstable equilibrium, externalities, limited information and mobility, and entrepreneurial incentives.

a. Unstable equilibrium

— We begin with the unstable equilibrium problem. Here some progress can be reported, if not a solution. A Nash equilibrium has been derived in the tax competition context. It appears in Mintz and Tulkens' model of two jurisdictions, each of which conditionalizes its optimal tax policy on the other's tax policy. The problem is that the model derives discontinuous reaction functions on the part of the two jurisdictions. That is, the a competing state's response sometimes departs from the result expected by the acting state, with the result that a Nash equilibrium does not emerge in some circumstances. When equilibria do exist, they are not Pareto optimal.¹⁸⁷ In addition, this model's character, if not its result, has been criticized. The charge is that the high degree of generality in this and similar models carries a cost. The critics insist that even if Mintz-Tulkens can show the emergence of a non-cooperative equilibrium in pure strategies, their insight offers few general characterizations or conclusions.¹⁸⁸

The custom in the tax literature is to assume that a stable equilibrium exists in a federalist economy¹⁸⁹ and go on from there to see the effects of different fiscal policies. The assumption weakens the models' predictive power. They in effect are better at pointing at possible distortions that can be expected to occur in a competitive federal system than they are at convincing us that the system is keenly competitive in the first place. Even so, they retain a powerful critical function for legal federalism, where just such a competitive system now routinely is assumed.

b. Externalities

— In the legal Tiebout world externalities tend to be put to one side as subject matter inevitably left over for central government treatment. In the tax models

¹⁸⁷ Jack Mintz & Henry Tulkens, *Commodity Tax Competition Between Member States of a Federation: Equilibrium and Efficiency*, 29 J. PUB.. ECON. 133 (1986). Each jurisdiction taxes a traded good and provides a local public good. The features of the model reveal that tax changes in one jurisdiction will impact the tax and price level in other jurisdiction. Because these effects are ignored by self-interested policy-makers, inefficiency emerges.

¹⁸⁸ Kanbur & Keen, *supra* note 182, at 878-79.

¹⁸⁹ See Inman & Rubinfeld, *supra* note 164, 313.

externalities take center stage as the subject to be modelled. The process of inquiry shows that the list of problems requiring central government treatment is longer than the legal Tiebout literature would lead one to expect.

c. Information

— Information presents less of a problem for the tax models than it does for the original Tiebout device. The reason is that when the tax models stipulate myopic government actors they imply a limited information world. In addition, the most important piece of information in a model of competitive tax-setting — the tax rate of the competing state — is observable. Questions still can be asked in a particular case about how much information real world government actors have about the fiscal effects of their tax policies, the probable actions of other states, and the preferences of their dominant coalition. But this questioning process need not be debilitating.

d. Mobility

— Mobility again is the mainspring with the tax models, with emphasis shifting to capital and transactions rather than citizen residency. There also is a twist. With pure Tiebout models, less mobility and less competition imply more distortion respecting public goods production. With the tax competition models, less mobility and competition means fewer externalities and less distortion. Either way, these mobility assumptions have to be backed up empirically if these models are to have policy import.¹⁹⁰ With the tax models, as with pure Tiebout models, it comes down to a matter of degree. A minimum degree of mobility-induced fiscal distortion is likely to be conceded by all observers — the connection between consumption taxes and the phenomenon of cross-border shopping is well-known. Studies offer additional support. Labor has been found to move across state lines in response to tax-related changes in the prices of goods and services.¹⁹¹ Results respecting tax-induced capital movement are less decisive,¹⁹² but some support is available.¹⁹³

¹⁹⁰ There also may be an analytical problem. See S. Bucovetsky, *Rent Seeking and Tax Competition*, 58 J. PUB. ECON. 337, 337 (1995) (arguing that an optimal equilibrium can emerge only if there is no migration (of capital or labor) needed to achieve efficiency; otherwise tax competition leads to too little migration).

¹⁹¹ Gregory I. Treyz, Don S. Rickman, Gary L. Hunt & Michael J. Greenwood, *The Dynamics of U.S. Internal Migration*, 75 REV. ECON. & STATISTICS 209, 213-14 (1993); Joseph Gyourko & Joseph Tracy, *The Importance of Local Fiscal Conditions in Analyzing Local Labor Markets*, 97 J. POL. ECON. 1208, 1227-28 (1989).

¹⁹² According to Inman & Rubinfeld, *supra* note 164, at 316.

¹⁹³ Leslie E. Papke, *Interstate Business Tax Differential and New Firm Location: Evidence from Panel Data*, 45 J. PUB. ECON. 47, 48-49 (1991).

e. Entrepreneurial incentives

— The tax models, like the Tiebout precedents, assume entrepreneurial incentives on the part of governmental actors. But the change of context makes the assumption more plausible. Here the payoff is not additional residents but additional tax dollars. As noted above,¹⁹⁴ although the need for these is indeed universal on the part of government actors, questions still can be asked about the degree of need, its connection to particular outcomes, and the role of competition in shaping those outcomes. But the problem materially lessens when the tax models admit interest group influence as an objective function. The stipulation that the dominant coalition prefers a given tax result technically solves the incentive problem because it ties the result pursued by government actors to the ballot box and, hence, to their interest in their own careers.

3. Neo-Tieboutian Tax Models

— A minority view in the tax competition literature argues to the contrary of the models just described. More particularly, the Krellove-Myers models¹⁹⁵ purport to show that state government activity does not imply fiscal distortions due to externalities and spillovers and that tax efficiency does not require central intervention. These models assume, (a) that local taxes are limited to head taxes and taxes on rents; (b) that all households have identical preferences and endowments; and, (c) that all governments set rates to maximize residents' welfare and recognize that resident welfare must equal that offered to residents in competing neighboring regions.

Here is the insight captured in the Krellove-Myers models. When, in the Krellove model,¹⁹⁶ the burden of a local tax on rents falls disproportionately on out-of-state property owners, there results a compensating in-migration of new workers. These new resident workers bid down wages. Wages fall in the amount of the tax subsidy provided by the out of state owners. Alternatively, in the Myers model,¹⁹⁷ the taxing government realizes in advance that the tax subsidy will attract new migrants and, to prevent the depression of wages, voluntarily transfers cash to out-of-staters. At the bottom line, no state has an incentive to export its tax burden because countervailing movement of factors or capital into the state over time will have an equilibrating effect that elimin-

¹⁹⁴ See *supra* text accompanying note 195.

¹⁹⁵ See Russell Krellove, *Efficient Tax Exporting*, 25 CANADIAN J. ECON. 145 (1992), and Gordon M. Myers, *Optimality, Free Mobility, and the Regional Authority in a Federation*, 43 J. PUB. ECON. 107 (1990).

¹⁹⁶ Krellove, *supra* note 195, at 153.

¹⁹⁷ Myers, *supra* note 199, at 108-109.

ates the advantage of subsidized public goods production.

This a powerful insight. But, in our view, it is not powerful enough to erode the position of the mainstream models. Although the other models continue to draw to some extent on Tieboutian assumptions, with Krellove-Myers as with the Hamilton equilibrium model, additional assumptions must be added. Inman and Rubinfeld criticize Krellove-Myers on this ground without denying that household relocation could have an equilibrating effect that neutralizes tax exportation. They wonder whether the correction would occur speedily. If it occurred slowly, there would remain room for fiscal myopia on the part of local politicians.¹⁹⁸ They note in addition that the mainstream models allow for a greater range of local tax devices and heterogenous citizen preferences, or, in other words, for politics as we commonly experience it. Given multiple types, the Krellove-Myers equilibrium would not generally be efficient.¹⁹⁹ Finally, they note the awkwardness of an assumption that local governments explicitly consider the effects of their fiscal decisions on relative household welfare across localities. Local government actors performing in accordance with this assumption are hyper-rational beings who perceive all external effects and subject them in advance to the equilibrating analysis of the Krellove-Myers model.²⁰⁰ Inman and Rubinfeld think the Gordon models' myopia assumption resonates better.

So do we. The Krellove-Myers models expunge the political factor that the other tax competition models accept into their objective functions. The expungement facilitates a solution to the problem of fiscal externalities and allows the reinstatement of a first-best presumption respecting junior level authority. But the models have to layer on the assumptions even then — the mainstream tax competition models presuppose neither homogenous preferences nor a universe limited to two tax devices. Krellove-Myers also aggravate the old Tieboutian problems of information and entrepreneurial incentives. To see this, contemplate the behavioral characteristics of the hyper-rational Krellove-Myers politician. Under the model's assumptions, this actor operates in a world of homogenous preferences and makes sure that the tax regime gives locals no welfare advantages over non-residents. Such behavioral characteristics approach those of the benevolent politician of the public interest theory of government of the 1950s and 1960s! The resemblance stands to reason. Krellove-Myers, like the Tiebout model itself, purports to claim a complete and

¹⁹⁸ Inman & Rubinfeld, *supra* note 164, at 324.

¹⁹⁹ Moreover, given elasticity of supply of all factors of production, there literally will be no rents to tax, returning us to the efficient but infeasible world of the Tieboutian head tax. *Id.* at 324.

²⁰⁰ *Id.* at 323.

spontaneous solution to local level public choice problems. For that to occur, a benevolent hand, whether visible or invisible, has to be at work somewhere.

It also should be mentioned that the interpolation into a tax model of a fully-informed, public-spirited government actor does not by itself guarantee a first best result. A recent model by Nechyba makes this assumption to show that such actors' attempts to reform distortive local tax regimes can be frustrated by citizen migration.²⁰¹ The model assumes that politicians are informed about the interjurisdictional effects of the taxes they set, but that citizens, who have immobile real estate holdings and mobile incomes, are myopic respecting the effects of their locational decisions. The model also assumes that politicians, subject to a budget balancing requirement, set taxes by choosing a proportion of a flat real property tax and a flat rate income tax and that citizens have heterogeneous preferences. The model shows what happens when politicians in one jurisdiction attempt to improve its tax system by increasing the proportion of the less distortionary income tax. Unsurprisingly, types whose income is high in proportion to real estate ownership react to the shift by moving out; meanwhile, immigrants attracted to the reformed tax system have low incomes in proportion to real estate owned and may include both high and low income types.²⁰² At the bottom line, the shift to the less distortionary tax causes the overall income of the jurisdiction and its tax base to shrink. Furthermore, an income tax, even if uniformly employed across the jurisdictions, will not result in a stable situation — politicians in each jurisdiction will have an incentive to lower the income tax and let the voters increase the property tax in response. Local politicians in effect are locked into the property tax despite its distortions.²⁰³

²⁰¹ Thomas J. Nechyba, *Local Property and State Income Taxes: The Role of Interjurisdictional Competition and Collusion*, Nat'l Bureau Econ. Research Working Paper 5419, Jan. 1996.

²⁰² The opposite results if the proportion of property tax is increased. *Id.* at 9.

²⁰³ *Id.* at 24. Interestingly, if there existed opposition to the property tax, there might exist a prisoners' dilemma in that politicians would be forced to introduce simultaneously an income tax, but every party would have an incentive to breach the agreement. This type of agreement is unlikely unless there is a third party which could monitor and police the agreement (for example, the state government). Since the state government can legislate a uniform tax and transfer the monies back to the local level, it is assumed that the state behaves as a enforcement body for the politicians' collusive agreement. For the record, Nechyba assumes that such a state grant system is an effective response to voter dissatisfaction with the property tax regime, particularly since it represents a low cost method to satisfy voter demands (and thus avoiding the migration effects) while satisfying their own preferences.

B. Asymmetric Information Models of Local Public Goods Production

Another, more tentative, line of public economics reconstructs the paradigm of jurisdictional competition for a second-best world, transforming it into a branch of the economics of asymmetric information and mechanism design. These models focus on the problem of an absence of incentives to induce government actors to produce local public goods at a marginal rate. To solve the problem, they propose revelation mechanisms that cause politicians and bureaucrats to tell the truth about their costs. The Tiebout mechanism is not necessarily discarded. But, by supplementing it, the models concretely acknowledge its inadequacy. Other models bypass it entirely on the ground that fails to offer a viable profile of an efficient public goods producer.²⁰⁴ These models substitute a political jurisdictional competition story²⁰⁵ in which casting a ballot replaces voting with the feet as the preference matching mechanism.²⁰⁶ Emphasis thereby devolves on information asymmetries that impair the vote's disciplinary effect.

1. *Information Revelation by Local Government Agents in a Tiebout Context*

— Can the interpolation of an additional preference matching device cure the Tiebout model's infirmities and make it a robust public policy tool? A model by Hoxby attempts to do this, claiming to enhance the responsiveness of local government in a Tiebout world²⁰⁷ by adding a new mechanism drawn from the theory of optimal regulation developed by Laffont and Tirole.²⁰⁸ We are not convinced that this exercise taken alone imports real world robustness to the Tiebout mechanism, but we agree that it takes the literature an important

²⁰⁴ See *supra* text accompanying note 132.

²⁰⁵ These models build on the political model introduced by Epplé & Zelenitz, *supra* note 139. Epplé and Zelenitz showed that sorting does not ameliorate the problem of fiscal rent extraction. Unlike early Tiebout work, they assumed an exogenous number of communities, inflexible community boundaries, and inactive landowners and developers. The role of politics was introduced by virtue of the fact that local government, given passive owners and residents, will attempt to maximize its tax revenues by usurping maximal land rents.

²⁰⁶ A simple experiential point further supports this switch — voting in elections offers a less costly alternative to migration. See Tim Besley & Anne Case, *Incumbent Behavior: Vote-Seeking, Tax-Setting, and Yardstick Competition*, 85 AM. ECON. REV. 25, 26 (1995).

²⁰⁷ Caroline Hoxby, *Is There an Equity-Efficiency Trade-Off in School Finance? Tiebout and the Theory of the Local Public Goods Producer*, Nat'l Bureau Econ. Research Working Paper 5265, Sept. 1995.

²⁰⁸ See LAFFONT & TIROLE, *supra* note 45.

step in this direction.

Hoxby presents us with a school board that actively pursues two goals: to provide quality education but not to have the price exceed the marginal cost. This entrepreneurial profile follows from two key Tieboutian assumptions — first, that residents already have sorted themselves into different school districts and that there is an equilibrium,²⁰⁹ and, second, that public goods producers have an incentive to limit costs since in the long run high cost providers will be forced to exit the market.

An information problem hobbles the school board as it tries to achieve its goal of quality production at the margin. Although school quality is observable by the board and the residents of the school district, it is not verifiable. The school board's agent, the administrator, reports actual costs, but the board does not know the parameters of the cost function. Such incomplete information makes rent extraction easy for the administrator and leads to diminished effort.²¹⁰

The industrial organization model, developed by Laffont and Tirole, shows that it is possible, via an information revelation mechanism, to obtain truthful information about the cost parameters of a regulated firm. According to the theory, the regulator's problem is that, due to hidden information, it must set a price for the firm's output based on the probability distribution respecting marginal costs, where the firm knows its actual marginal cost has no incentive to report it truthfully. The theory shows us that the regulator can use the probability distribution to design a price menu based on an optimal combination of rents allowed to the firm and surplus supplied to the consumer. The menu facilitates the maximization of expected economic welfare under conditions of information asymmetry.²¹¹

Applying the theory in her school model, Hoxby assumes two types of school administrator, efficient and inefficient, and then introduces two menus, incen-

²⁰⁹ Otherwise, there would be an incentive for resident groups to migrate to high quality school districts.

²¹⁰ Assuming that there are low and high cost school administrators, the informational asymmetry allows low cost types who might be forced to invest in productivity gains to capture rents. The social costs of these rents may prevent high cost types from making productivity enhancing investments.

²¹¹ And under the incentive and individual rationality constraints of the regulated firm. Under an incentive-compatible regime the regulator is positioned to offer an optimal tradeoff between control of rents to the firm and the transfer of surplus to consumers.

tive compatibility for the efficient type and inefficient rationality for the inefficient type. Under the incentive compatibility constraint, the efficient school — that is, the school with low cost or high demand parameters — can mimic inefficient school. That is, the information asymmetry permits the efficient school to decrease its effort level for each level of improvement in its cost or demand parameters. The trick in the model comes when the regulator offers a side payment to both types of school administrator. Given this offer, the efficient school will provide truthful information concerning its cost and demand parameters and the average cost to produce the good. More particularly, the efficient, low cost school will have an incentive to select a low subsidy and a high marginal side-payment. In contrast, a high cost school will choose the converse combination. The upshot of the menu approach is that it allows the regulator to take account of this observable but unverifiable information about the schools' cost parameters in setting the price schedule.²¹²

Hoxby couples this Laffont-Tirole revelation mechanism to a short-run Tiebout mechanism. She thereby offers a solution to one of the Tiebout model's primary information problems, that of the unverifiable quality of many public goods. If this information problem were the only friction impairing Tiebout mechanism's viability as a basis for policymaking, this might be the breakthrough showing. But information asymmetries are not the only significant friction that must be confronted. This point emerges when we reexamine the model's assumptions: The school board desires to produce at the margin because otherwise population loss will put the jurisdiction out of business. For such an incentive to obtain, every other assumption on the Tiebout list has to be left in place.²¹³ But, as we have seen, those assumptions do not describe the real world. Hoxby, then, has not delivered an entrepreneurial public goods producer and we have no basis to predict that the school board will design a revelation mechanism in the first place.²¹⁴ The model's accomplishment must

²¹² The importance of a revelation mechanism is that it effectively introduces a cost and quality index to assist the board in its pursuit of reducing costs and increasing school quality.

²¹³ Indeed, if that were the case we would be in a first-best world and the school administrator would share the school board's incentive to produce at the margin for fear of losing her job due to bankruptcy. On such a scenario, the administrator has every incentive to tell the truth, eliminating the information asymmetry!

²¹⁴ The device presumably would have to be imposed by a higher governmental authority as a process and structure reform.

Some problematic preconditions to the operation of the Laffont-Tirole paradigm also might be mentioned. The model assumes that the regulator has the first-mover advantage by means of a take it or leave it offer. As this assumption is relaxed, a commitment problem

be narrowly stated: Given a Tiebout mechanism on the demand-side there is in theory a mechanism that can ameliorate supply-side information problems and realign supply-side incentives in a productive direction.

2. *Yardstick Competition*

— Yardstick competition models seek to ameliorate the Tiebout model's shortcomings by abandoning mobility as the source of competitive incentives and substituting the vote. More specifically, these models posit that a form of jurisdictional competition obtains when voters demand that their governments do as well as governments in other jurisdictions in providing low cost, high quality public goods. In so doing, these models draw on a specific branch of the agency literature — the theory of tournaments.²¹⁵ Once again the focus

arises and it becomes impossible to predict that the bargaining process will always result in an efficient outcome. In the alternative, the regulated firm may test the regulator's commitment to a policy by refusing to participate, leading to a temporary breakdown of negotiations. In this case, the regulator will find it difficult to make credible commitments for the entire policy period, for example, by refusing ever to make another offer to the firm. See David P. Baron, *The Economics and Politics of Regulation: Perspectives, Agenda, and Approaches*, in MODERN POLITICAL ECONOMY, OLD TOPICS, NEW DIRECTIONS 13 (Jeffrey S. Banks & Eric A. Hanushek, eds. 1995).

²¹⁵ In contrast with standard incentive devices, tournaments look to the relative performance of each agent rather than individualistic compensation schemes. This literature was developed originally to examine the conditions of labor market competition. See Edward Lazear & Sherwin Rosen, *Rank-Order Tournaments as Optimum Labor Contracts*, 89 J. POL. ECON. 841 (1981); Bengt Holmstrom, *Moral Hazard in Teams*, 13 BELL. J. ECON. 324 (1982). It has been extended to analyze the role of competitive compensation schemes in economies with imperfect information. See Barry Nalebuff & Joseph Stiglitz, *Prizes and Incentives: Towards a General Theory of Compensation and Competition*, 14 BELL J. ECON. 21 (1983).

The tournament models concern information problems in principal-agent relationships. They assume that while the input of agents is not directly and costlessly observable, it is possible to establish an incentive scheme or reward structure, tied to individual output. They make a substantive advance in offering a lower cost method to capture information (and reduce risk levels) while remaining sufficiently flexible to accommodate different environments. See Andrei Shleifer, *A Theory of Yardstick Competition*, 16 RAND J. ECON. 321, 323 (1985). The models also provide a means to screen agents.

Some shortcomings should be noted. While the models do capture the idea that compensation schemes can lead to increased effort where there is sufficiently high motivation (as in the case of law firm rat races), they do not always guarantee a first best level of effort. See Nalebuff & Stiglitz, *passim*, at 41. Moreover, experimental work suggests that the theory is robust in predicting average behavior across tournaments but is less

is on information asymmetries.

The leading treatment comes from Besley and Case.²¹⁶ This is a two-period, multijurisdictional model of tax setting that, like the Hoxby model, follows the pattern of the game theoretic models developed in the industrial organization literature. The model assumes that voters' choices and incumbent behavior are determined simultaneously and that incumbent politicians decide whether to increase taxes based on the tax policies of other jurisdictions. Voters and politicians are asymmetrically informed, with the politicians being better informed²¹⁷ about the cost of supplying public goods. Politicians, meanwhile, come in two types — good types who are responsible to voters and do no rent-seeking, and bad types who finance their career concerns at the expense of voters' interests.²¹⁸ The rent-seeking politician adds to the marginal cost of public goods by adding costs, low or high. There also are three different external shock values — low, medium, and high — to which politicians respond in setting tax levels. The asymmetrically-informed voters must decide

successful in predicting behavior in a single tournament. See Clive Bull, Andrew Achotter & Keith Weigelt, *Tournament and Piece Rates: An Experimental Study*, 95 J. POL. ECON. 1, 3 (1987).

When the discussions of the tournament literature involve political agents, the model is adapted to focus on competition between governments. Pierre Salmon, *Decentralization as an Incentive Scheme*, 3 OXFORD REV. ECON. POL. 55 (1987). This analysis is predicated on the assumption that the essential problem is that voters are not fully informed concerning the quality of the politicians' input and that voters use the performance of other politicians as a benchmark regarding their own politicians' policies (taxation). BRETON, *supra* note 87, at 234. See also Pierre Salmon, *The Logic of Pressure Groups and the Structure of the Public Sector*, 3 EUR. J. POL. ECON. 55 (1987).

²¹⁶ The Besley and Case model addresses the literature on the 'flypaper effect' (money sticks where it hits), which points to the possibility that bureaucrats, because of their control of the agenda at the local and state level, can expand the level of public goods output beyond the demand of the median voter. See, e.g., Thomas Romer & Howard Rosenthal, *Bureaucrats versus Voters: On the Political Economy of Resource Allocation by Direct Democracy*, 93 Q. J. ECON. 563 (1984) (showing that bureaucrats can set higher budgets because of their information advantage over voters and the fact that voters are hostile to an alternative, reversion budget). This literature is deemed to be hostile to the Tiebout literature because it suggests that jurisdictional competition is insufficient to provide needed fiscal discipline. See Wallace E. Oates, *Federalism and Government Finance*, in Quigley & Smolensky, *supra* note __, at 135.

²¹⁷ The model follows recent work on asymmetric information and the political agency problem: See Ken Rogoff, *Equilibrium Political Budget Cycles*, 80 AMER. ECON. REV. 21 (1990).

²¹⁸ It is assumed that the politicians know each other's type.

as to their incumbent's type based on performance.²¹⁹ The model stipulates that the voters have an indirect informational means to assess the incumbents' performance. Specifically, they observe the tax policy and public goods performance relative to that of other jurisdictions. That information is employed to set a benchmark to measure the incumbent's performance,²²⁰ thereby to determine the incumbent's type and suitability for reelection.

A range of both pure and mixed strategies emerges in Besley and Case's formal analysis.²²¹ Here, by way of example, are a few results. Assume first that voters do not have access to information about tax and public goods production in other jurisdictions. These voters are likely to reelect an incumbent when the incumbent sets an intermediate level tax, assuming a stochastic shock with a high enough value that insures that an incumbent who has selected this level is indeed a good type. But, at the same time, a bad incumbent can gain reelection on this fact pattern by falsely signalling goodness through a medium reduction in his rent. Now assume that these voters have access to information about the tax level in another, identical jurisdiction. Three possibilities emerge: (a) if both incumbents are good, then there obviously will be no added tax cost of public goods; (b) if both incumbents are bad, then there is a perfect Bayesian equilibrium for the two incumbents — both will reduce rents when the cost shock is medium; and (c) if one incumbent is bad and the other is good, the bad incumbent will be found out if she sets a higher tax than the good incumbent and is unable to follow the neutral strategy of lowering her rent; in this case, by virtue of the yardstick mechanism, taxes are lower in the second period.

Thus does the model show that a reelection mechanism can discipline incumbents by forcing them to increase their effort level. Besley and Case go on to note that this approach is analytically inconsistent with the Tiebout approach in a significant respect. In a Tiebout world, where citizens would migrate according to their tax and public goods preferences, citizens dissatisfied with

²¹⁹ The voters observe their elected politicians' tax-setting behavior in the game's first period. It is assumed that voters prefer to minimize their expected second period taxes and so base their beliefs about the politicians type on period one behavior.

Since the transmission of information is noisy, incomplete, and expensive, it is unlikely that any citizens will invest in monitoring the performance of politicians. Opposition politicians cannot be relied on because they are just as untrustworthy as the incumbents. The voters accordingly need an alternative source of credible information.

²²⁰ There are, of course, other mechanisms to discipline politicians, such as party control.

²²¹ The scenario leads to a perfect Bayesian equilibrium (this generates an equilibrium in which voters and politicians have rational expectations).

the incumbent's first period tax level presumably move rather than stay around to vote no. On the other hand, Besley and Case note the possibility of a hybrid model in which higher taxes lead to capital flight, with the capital flight depressing property values and prompting general voter dissatisfaction.

This model, then, breaks with the Tiebout approach at a technical level. But significant commonalities persist at an aspirational level. The yardstick competition approach shares the Tieboutian preference for decentralized government and the view that competition between governments can lead to superior outcomes. Indeed, the stress on information asymmetries comes coupled with an assertion that better information gives state and local government an efficiency advantage. As between an aggregated national information base and a local information base, the latter is said to provide better guidance for the design of regulatory policies and incentive structures. Due to the small numbers the politicians know more about the voters and vice versa.

Besley and Case conclude that their tax-setting/vote-seeking story embodies an insight superior to that of the Tiebout mobility story. They have a point. Projected election results certainly matter more to politicians in the ordinary course than do comings and goings of residents and capital, and politicians certainly do set taxes strategically with voting results in mind. But acknowledgment of the approach's relative superiority does not by itself signal robustness for policy purposes. Here is the question: Given present institutional arrangements, to what extent do voter performance comparisons determine state and local election outcomes? Besley and Case address this question with an empirical study of tax setting and gubernatorial election results.²²² The results show that tax changes in a neighbor state have a positive and direct effect on a state's tax equation²²³ and that a tax increase increases the probability of incumbent defeat. These are interesting results. But they do not support the conclusion that vote causes state and local spending levels meet

²²² They examined tax changes observed in neighboring jurisdictions and incumbent governor defeats using tax data for two income classes — joint-filers earning \$40,000 and \$100,000 respectively in 1977 without dependents. See also Anne Case, et al., *Budget Spillovers and Fiscal Policy Interdependence: Evidence from the States*, 52 J. PUB. ECON. 285 (showing that expenditure changes respond to spending decisions made in other jurisdictions).

²²³ For example, a one-dollar increase in neighbors' taxes results in roughly a 20-cent increase. *Id.* at 38. These results reflect the assumption that given the different measures of state taxes, they are likely to respond differently to changes in economic and demographic factors.

citizen preferences in any absolute sense.²²⁴ Nor do they tell us that state and local regulation is otherwise unimpaired by interest group rent-seeking. Under this model, after all, if bad types predominate in the population of government actors, then bad outcomes follow whatever the level of voter information. On that scenario, state and local government have no apparent advantage over central government other than the fact that the local information base may prove better outfitted for interest group rent-seeking!

C. Summary

The new approaches to jurisdictional competition send a complex signal. The tax competition models make modified Tieboutian assumptions to give us a detailed picture of market failure at the state and local level. To the extent that a legal observer deems the assumptions to weaken the results, this literature has little import for legal federalism. Contrariwise, to the extent a legal observer accepts the Tiebout model despite its infirmities, these models indicate that the mode of application of jurisdictional competition in legal context needs root-and-branch revision. These models tell us that productivity gains through devolution cannot be assumed, even given Tieboutian assumptions. A plausible showing must include an exhaustive review of possibilities for distortive fiscal effects.

The asymmetric information models show us that jurisdictional competition models may look quite different in the future. The interpolation of the Laffont-Tirole model of incentive-compatible regulation solves one of the many information problems assumed away in the Tiebout model. But it does not import a synergy that clears away all the other sticking points, transforming the school board into the functional equivalent of an at-the-margin private producer. The yardstick competition approach takes us one step farther toward that goal by switching our attention to the vote as the disciplinary mechanism. But we still do not realize the ideal of responsive local government. This model makes some troublesome assumptions — first, that voters evaluate their government by comparing it to similarly situated governments, and, second, that common voter preferences prevail across jurisdictions.²²⁵ Clearly both

²²⁴ Also, the model must be contextualized in order to account for the range of demographic and economic conditions which impact on the tax increases in certain states. The existence of both anticipated and unanticipated shocks means that, unless voters are capable of making the correlation between the two forms of shock, it is assumed that they respond to change whether it is anticipated or not.

²²⁵ BRETON, *supra* note 57, at 189, 233-34. The models also assume that any mobility based competition between jurisdictions is not for the movement of people but resources.

conditions exist to some extent in the real world. But it stretches credulity to suggest that they prevail so powerfully as to solve the incentive problem in respect of public goods. It may be that junior level democratic political institutions can be designed so as to induce beneficial rivalrous behavior. But such designs have yet to be specified.

The models' focus on information asymmetries suggests a route to the ultimate test of the robustness of the law as product analogy. If the analogy is robust, then the remedy of regulatory and political information asymmetries should, by itself, solve junior level public choice problems. If law is not product, then transparency by itself will not assure its efficient production.

IV. IMPLICATIONS FOR LEGAL FEDERALISM

The first part below sets out recommendations for legal federalism that follow from our analysis of the economics. The second part below makes some observations respecting the economics' application in regulatory competition situations. Recall that the formal models for the most part concern local public goods and that regulatory competition theory informally extends them to outputs of regulation. The shift of context can affect the model's application. In some regulatory competition situations, the model applies with greater robustness than is the case with local public goods, as we show with respect to corporate law and analogous situations. In other cases, the models' problematics carry over unabated, as we show to be the case with environmental law.

A. A Suitability Standard for Claims of Competitive Benefit

1. Implications for Legal Federalism's Devolutionary Presumption

— The economics of jurisdictional competition suggest that legal federalism makes two unjustified predictive leaps. The first is the view, shared by both race-to-the-top and race-to-the-bottom proponents, that decentralization by itself means that competition will be formative influence on terms of regulation. The economics identify significant frictions — product bundling, mobility costs, spillovers, information asymmetries, and the lack of a public goods entrepreneur — that inhibit appearances of competitive lawmaking in practice. This implies that regulatory subject matter needs categorization. Some will be

structurally suited to competitive influence and some will not. Accordingly, legal regulatory competition theory needs to avoid making a general prediction and instead should articulate a suitability test.

Legal federalism's second questionable prediction is that, assuming decentralized regulation subject to significant competitive influence, competition will lead to a first-best outcome. The economics provide no tractable basis for predicting stable, long-term equilibria in competitive lawmaking situations. This problem respecting outcomes is exacerbated by two factors. First, the federal system holds out limitless possibilities for externalization of costs, possibilities that are more likely to be realized given competitive behavior. Second, given the Tiebout mechanism's failure to make good on its original claim to import a discipline that solves public choice problems, any claim of welfare enhancement through devolution must take account of the possibility of junior level interest group rent-seeking.

As we have seen, public economists are working on all of these problems. But they have not yet provided general solutions. The legal literature is left overstating the connection between decentralization, competitive behavior, and efficient results.

This conclusion does not imply a counter-presumption favoring federalization. Nor does it controvert other public economics observations respecting junior level regulatory benefits. Recall that public economics articulates an independent claim of junior level advantage with the decentralization theorem. This stresses that preferences are more likely to be satisfied in small numbers situations, an observation reinforced by the literature of asymmetric information.²²⁶ The theorem also asserts that regulatory experimentation is more likely to occur when a large number of jurisdictions all confront the same problem.²²⁷ Nothing in our analysis detracts from the force of these

²²⁶ Assuming of course that provision at a senior level of government holds out no cost advantages. See *supra* notes 52-61 and accompanying text.

²²⁷ Serious doubts have been raised about the robustness of this claim. One problem is that it is advanced absent a profile of the levels of risk aversion of government actors at various levels. See Susan Rose-Ackerman, *Risk-Taking and Reelection: Does Federalism Promote Innovation?* 11 J. LEGAL STUDIES 593 (1980) (arguing that local politicians are more risk averse than are federal and that therefore innovation should be expected at the federal level). In addition, just as law may be analogized to product, so law, once seen as product, may be analogized to technology. Unlike many technological innovators, lawmakers seeking returns on investment face a public goods problem. Moreover, once technical complexity is present, product competition does not by itself assure innovation,

points.²²⁸ But, significantly, the decentralization theorem makes claims of a much lesser magnitude than the does the Tiebout model. It speaks only in terms of probabilities and makes no absolute claims about the quality of the projected result. As such it folds easily into traditional federalism dialogues. We suspect that many observers would comment that traditional federalism already instantiates its points. All other things being equal the states have always gotten the nod, and the line about product experimentation finds its most famous articulation in Justice Brandeis' reference to the states as social laboratories.²²⁹ Jurisdictional competition theory, in contrast, purports to preempt thorough-going discussion about appropriate level of regulation by ascribing determinative benefits to the states.

We also note that our analysis neither denies that jurisdictional competition occurs in the real world nor implies a presumption of negative effects.²³⁰

as is shown by the application of the economics of network effects, *see* Klausner *supra* note 115, and patent races, *see* Ayres, *supra* note 70, in the law as product context.

²²⁸ We have more doubts about the robustness of the Leviathan theory of the public choice literature, *see supra* notes 54-56 and accompanying text, which advances the idea decentralization acts as a constraint on the budget-maximizing bureaucrats. Few of the empirical studies are supportive of the thesis that size of government varies inversely with the extent of fiscal decentralization. *See* Wallace E. Oates, *Searching for a Leviathan: An Empirical Study*, 71 AMER. ECON. REV. 748 (1985); James Heil, *Searching for a Leviathan Revisited*, 19 PUB. FIN. Q. 334 (1991). The discussion is by no means settled, however — there are now two studies to the opposite effect. *See* Jeff Zax, *Is There a Leviathan in Your Neighborhood?*, 79 AMER. ECON. REV. 560 (1989); Randall W. Eberts & Timothy J. Gronberg, *Can Competition Among Local Governments Constrain Government Spending?*, 24 ECON. REV. 2 (Fed. Res. Bk. Cleveland, 1988). Oates replies in turn that 'there is not enough unambiguous support available to make a convincing case that decentralization in itself constrains government size. If we want smaller government, then other measures are probably in order'. Wallace E. Oates, *Federalism and Government Finance*, in Quigley & Smolensky, *supra* note 87, at 148.

We also note the appearance of a counterstory reflecting political developments of the past decade and a half, *see* Reiner Eichenberger, *The Benefits of Federalism and the Risks of Overcentralization*, 47 KYKLOS 403, 407-409 (1994). Eichenberger contends that centralization weakens the demand for public goods and as a result limits the size of the budget. *Id.* Citizens (a) opt out of the system when government actors do not respect their preferences, (b) react to government rent-seeking activities since they have to shoulder resulting welfare and budgetary costs, and (c) respond to increasing centralization and government exploitation by enacting legislation that limits taxation and electing politicians who support such initiatives. *Id.*

²²⁹ *See* *New State Ice Co. v. Liebmann*, 285 U.S. 262, 311 (1932) (Brandeis, J. dissenting).

²³⁰ Nor does our analysis imply rejection of the body of legal scholarship on regulatory

Instances of state and local government competition cannot be denied. States and localities routinely make taxing and spending decisions under competitive stress, stadium deals for professional sports teams and tax breaks for firms locating new plants being obvious examples.²³¹ In addition, entire areas of law manifestly have been shaped by competition, corporate law being the prime example. The competitive corporate law system, although not first-best, holds out significant benefits of responsiveness to business interests and technical expertise in its regulators.²³² We even agree that regulatory competition appropriately may be termed a federalism value, at least at a broad structural level. We would not, for example, dispute a prediction that relocation by citizens, factors, and capital would frustrate the plans of a state that attempted to cartelize an industry or confiscate the wealth of a class of firms.²³³

2. *Suitability Standard, the Race-to-the-Top, the Race-to-the-Bottom, and the Prisoners' Dilemma*

— Legal federalism needs to stay in closer touch with the terms of the public economics if it is to plausibly connect junior level competition and economic welfare. Two structural adjustments should move the discourse in this direction. First, the list of barriers to first-best competitive results should be restated as a suitability standard. Second, the race-to-the-top and race-the-bottom concepts should be discarded as misleading.

A claim that competitive benefits redound, presently or prospectively, from the vesting of regulatory authority at junior level will be more plausible where (a) the regulation is unbundled, (b) the regulation implicates no substantial interconnections with other jurisdictions or with later consumers, (c) all actors affected by the regulation are highly mobile, (d) all actors are well-informed, and (e) competitive pressures registered by all actors affected by the regulation determine its content. To the extent that one or more these variables does not

competition. To the contrary, we think that situation-specific legal applications provide a useful source of material for demonstrating the theory's shortcomings.

²³¹ Peter D. Enrich, *Saving the States from Themselves: Commerce Clause Constraints on State Tax Incentives for Business*, 110 HARV. L. REV. 377 (1996), confirms this with an excellent report on the landscape.

²³² Our view is articulated in William W. Bratton & Joseph A. McCahery, *Regulatory Competition, Regulatory Capture, and Corporate Self-Regulation*, 73 N.C. L. REV. 1861 (1995).

²³³ See Weingast, *supra* note 6, at 5.

obtain, the case for competitive benefits weakens.²³⁴ Meanwhile, a proponent with a strong claim should be able to describe a causal connection between the mechanism of competition and the claimed beneficial outcome, showing the impact on the alignment of interest group politics and other factors that influence regulatory outcomes in the competing jurisdictions.

Claims of competitive detriment may be slightly easier to sustain under this standard. Unbundled regulation and mobility still will have to be shown. But this proponent can omit positive showings respecting information, input by all affected parties, and an absence of externalities. Instead, a negative showing respecting these factors advances the claim. We also note that there is a strong case for relaxing the requirements of showing state level mobility and well-informed actors where jurisdictional competition theory is drawn on to support centralized wealth redistribution policies. The point that negative competitive effects at junior levels require redistribution policy to be centrally managed has been central to jurisdictional competition theory from the very beginning. Nothing in the literature of Tiebout problematics disturbs this application.²³⁵ There also is backing from a highly suggestive body of empirical studies.²³⁶

²³⁴ Compare Easterbrook, *supra* note 24, at 34-35, which also sets out a suitability test based on the Tiebout model's assumptions. According to Easterbrook, exit will cause a 'powerful tendency toward optimal legislation' to the extent four conditions are satisfied: (a) mobile people and resources, (b) a large number of jurisdictions, (c) jurisdictions free to enact any law they desire, and (d) all consequences felt within the jurisdiction. See also Rice, *supra* note 25 at 54-55. In our view this test is incomplete, because it omits product bundling, limited information, and interest group politics.

²³⁵ Wilson, *supra* note 157, carries this point to its logical conclusion and argues if the power to set and implement redistributive policies is vested at multiple levels of government, then it is always open to one level of government to undermine income policies promulgated at another level. Junior level policy coordination remains a possibility, but might increase the overall costs of achieving an optimum level of income distribution. Viewed through the lens of regulatory competition theory, strongly stated, such coordination would in any event be a diluted form of centralization. Thus the problems of taxation and distribution can be solved only through coordination by the central government.

²³⁶ See *supra* note 157. This point has been made powerfully in connection with recent welfare legislation, although not so powerfully as to have had an impact in Washington. See Paul E. Peterson, *Devolution's Price*, YALE L. & POL'Y REV./YALE J. REG. SYMPOSIUM ISSUE 111, 112-19 (1996) (citing additional empirical literature); Note, *Devolving Welfare Programs to the States: A Public Choice Perspective*, 109 HARV. L. REV. 1984, 1987-89 (1996).

Obviously, redistributive programs are implemented at the state and local level; interjurisdictional pressures simply contain their magnitude. For discussion see Kaplow, *supra* note 12, at 472-79.

The retirement of the race-to-the-top and race-to-the-bottom concepts makes sense for a number of reasons. The frictions that inhibit the Tiebout mechanism may prevent a race from breaking out in the first place. Even given a race, the equilibrium discussion teaches us that is unlikely ever to reach the top, or even if it does reach the top it is unlikely to remain there for very long. In addition, the capacious concept of externalities applied in the tax competition literature teaches us that, even given the most promising-looking subject matter for competitive lawmaking, there remain possibilities for distortive externalities. As a result, even with keen competition, central authority will have to stand by to make adjustments. Race-to-the-top rhetoric obscures all of these points.

The race-to-the-bottom concept, in its turn, is not an effective vehicle for challenging weak claims for competitive benefits. The concept makes an unnecessary concession when it assumes intense junior level competition. And its all-purpose prisoners' dilemma story has been rebutted persuasively.²³⁷ Meanwhile, the tax competition literature shows that an important point about distortive competition has been overlooked in legal discussions: *A showing of downward directed competition* — whether at a race or a walk and whether or not reaching the bottom — *does not presuppose a prisoners' dilemma*. An assumption of government myopia and an open economic concept of an externality provide a capacious framework.²³⁸ Of course, as noted above, the myopia assumption has been controverted within public economics. But, as a particularized instantiation of the familiar concept of bounded rationality, it should resonate quite well in legal contexts. Finally, nothing in the economics *per se* delegitimizes political and public interest justifications for centralization in legal contexts.

3. Scare Talk

— One likely objection to our analysis of the economics needs to be discussed. It is sometimes said that actual mobility is not necessary for operation of the Tiebout mechanism. Exit need not occur, it need only be threatened. To see this, hypothesize a decentralized regime in which (a) citizens, factors, and capital are very mobile, (b) the content of regulation figures into locational

²³⁷ See *supra* text accompanying notes 67-71. Although we note the formal economics does confirm that prisoners' dilemmas can be made out in jurisdictional competition situations. See *supra* note 162.

²³⁸ Cf. Richard Briffault, *The Local Government Boundary Problem in Metropolitan Areas*, 48 STAN. L. REV. 1115, 1147 (1996) (localities acting in own interest will not decide optimally because they will not take regional interests into account).

decisions, (c) interest group deals determine the content of regulation in each jurisdiction, and (d) the attraction of new citizens, factors, and capital does not affect the content of the interest group deals. Competition does not shape the law in this system in a purposive sense. Yet, so long as mobility obtains and regulation affects locational decisions, the regulatory *status quo* affects the movement of citizens, factors, and capital. A prediction that movement could become a lawmaking influence as conditions change over time is justified. The potential for future competitive influence can be seen as a benefit intrinsic to any decentralizing initiative. On this picture, regulatory competition legitimately can figure into policymaking calculations whether or not it presently influences regulation or is likely to do so in the immediate future. It need only be a possibility.²³⁹ The argument finds additional support in the contestable markets approach to antitrust, under which the possibility of attracting new entrants into a monopolized market served as an adequate market discipline on the monopolist.²⁴⁰

The argument is a good one. But the question is whether, taken alone, it displaces the economics of Tiebout problematics to support devolutionary initiatives on an 'as if' basis. We would answer no, and these preemptive competition arguments to one side for situation-specific application. We note first that the contestable markets view is rejected under a succeeding economics of monopoly. Given a long list of imperfections — including downward sloping demand, nonconvexities, and imperfect information — potential competition is now thought to have limited effects and not to provide a basis for a regulatory presumption.²⁴¹ The analysis of the infirmities of regulatory competition works similarly. Given the sticking points, there is a good possibility that preemptive competition arguments become 'cries of wolf' over time. They will sound plausible for a while, but in the event competition does not in fact break out they will not remain credible over time.²⁴² Indeed, even the first-time call for a preemptive response need not be determinative. The issue is joined when the opponent suggests that the jurisdiction wait and see if the

²³⁹ See, e.g., Perry, *supra* note 34, at 738-46 (arguing that the SEC should amend its regulations to facilitate competition with foreign markets for equities even though domestic companies still issue equity at home, because competition will come in the future).

²⁴⁰ See Harold Demsetz, *Why Regulate Utilities?* 11 J. L. & ECON. 55 (1966); *supra* note 35.

²⁴¹ See STIGLITZ, *supra* note 116, at 119-125.

²⁴² An exception for wealth redistribution policy again may be appropriate. Here the cry of wolf is made when a local welfare regime threatens to draw poor people to the jurisdiction. Given the prejudice against the poor in American society, the cry may prompt action on the thinnest of empirical bases.

predicted competitive situation actually occurs. On this analysis, the preemptive call carries the most weight in a situation where the proponent can show a first mover advantage in a potential competitor state.²⁴³ Delay has a cost in that case. Otherwise, the jurisdiction that sees a countervailing policy reason not to try to compete might as well wait and see, standing ready to copy the first mover in the event a competitive outbreak causes injury.²⁴⁴

B. Implications for Regulatory Competition

The economics of jurisdictional competition focus primarily on local public goods production, and do not tend in terms to address regulatory competition situations. The transition of context to regulatory competition can cause the precepts of the theory to apply differently than in public goods situations. Much of the differential can be accessed by grouping regulatory competition situations into two categories. In the first, conflict of laws rules apply so as to put firms or individuals in a position to select among a number of jurisdictions for the situs of a legal relationship, and the jurisdictions compete for their business. In the second, product competition across jurisdictional lines prompts competitive lawmaking by governments either pursuing new citizens, factors, and capital or attempting to confer competitive advantages on existing residents. Both categories overlap at points with local public goods production and related tax policy.

1. Competition to Confer Legal Status

— The clearest cases of regulatory competition arise when a conflict of laws regime makes it possible for actors to choose a nominal jurisdictional situs for a firm, transaction, or other legal relationship. If this choice produces rents for the jurisdiction selected in the form of taxes, fees, transactional expenses, or enforcement expenses, then there arises an incentive to shape the applicable law to suit the selecting actors' preferences. Corporate law is the classic case. Corporate actors may choose their state of incorporation without regard to the location of the firm's physical assets. The states have been competing for chartering business for a century, offering reincorporating firms attractive codes and ancillary services in exchange for franchise tax revenues.

²⁴³ See Jennifer G. Brown, *Competitive Federalism and the Legislative Incentives to Recognize Same-Sex Marriage*, 68 SO. CAL. L. REV. 745 (1995) (discussing economics of first mover advantage).

²⁴⁴ See Ayres, *supra* note 70 (discussing the ease of copy cat responses on the part of follower states).

Competition for incorporations also has emerged internationally, if on a lesser scale. National tax systems vary in the bases on which they prescribe jurisdiction; firms (and individuals) can exploit the systems' limitations by situating themselves and their transactions in offshore tax havens.²⁴⁵ What has gone for the chartering of firms also has gone for the registration of ships — a handful of leading jurisdictions offer regulatory havens to ship owners worldwide.²⁴⁶ This pattern of competitive lawmaking is not limited to the siting of commercial relationships. Liberal marriage and divorce rules can produce tourist revenues for jurisdictions accessible to population centers with more restrictive family law regimes.²⁴⁷

The literature of Tiebout problematics shows us why the sale of status shows up in practice as the clearest case of regulatory competition. Simply, here the problem of the entrepreneurial government actor is solved. Nominally sited legal relationships such as incorporation and marriage are unbundled legal products that can be sold separately to foreign consumers. Their provision leads to a two-party transaction resembling a conventional sale of goods. With customers of means, such as wealthy individuals or large firms, mobility presents a cost but not a barrier. Verifiability either presents no problem, as with marriage and divorce, or readily may be delegated to the judgment of a legal professional. The intermediary role of lawyers is especially prominent with corporate law. Reincorporating firms can choose among 50 state codes. They base their decisions on information channelled through their lawyers (and their investment bankers).²⁴⁸ Lawyers, in turn, draft the state codes from which the reincorporating firms select. Their participation has contributed to

²⁴⁵ A 1985 Senate Committee Report identifies 29 tax haven jurisdictions worldwide. S. COM. ON GOV'TAL AFF., *Crime and Secrecy: The Use of Offshore Banks and Companies*, S. REP. NO. 130, 99th Cong., 1st Sess. 29-31, 33-34 (1985). The largest of the states on the list are Austria, the Netherlands, and Switzerland. *Id.* The report lists three distinguishing characteristics: Low or nonexistent taxes on foreign source income; bank secrecy; and banks and financial institutions with a dominant role in trade and commerce. *Id.*

²⁴⁶ The leading open registry states are Liberia, Panama, Singapore, Cyprus, and Vanuatu. J. Wells, *Vessel Registration in Selected Open Registries*, 6 MAR. L. REV. 221, 221-223 (1981). They offer easy registration procedures and free transferability, no income taxes, no restrictions on manning by foreign nationals, and no other significant domestic regulations. *Id.* Registration in an open registry jurisdiction increases the market value of the ship. *Id.*

²⁴⁷ At one time Nevada divorces were the primary example. Today the question is whether the point might obtain for same sex marriages. Brown, *supra* note 243.

²⁴⁸ ROMANO, *supra* note 37, at 43-44; Jonathan R. Macey and Geoffrey P. Miller, *Toward an Interest Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469 (1987).

an evolutionary of convergence on the basic terms of the 50 state codes and the appearance of a focal point model code. As a result, despite 50 alternatives, reincorporation presents a manageable informational problem.

As to these relationships, then, law may indeed approximate product. But, significantly, status entrepreneurship is not a game any status-providing jurisdiction can play. Particular conditions tend to obtain in jurisdictions in which product sales become wrought into the lawmaking structure. Sufficient competitive incentives do not show up throughout the class of potential suppliers. Small jurisdictions tend to take leading competitive roles: Delaware is the jurisdiction of incorporation of about half of the corporations listed on the New York Stock Exchange; small island states tend to offer themselves as tax havens; Liberia, Panama, and Greece lead in the registration of ships. The explanation prevailing for Delaware probably applies across the board. Corporate franchise fees amount to 15 percent of Delaware's tax base; the same cash flow would be a trivial percentage of the tax base of a large state. Given a limited market, competitive success has a larger percentage impact on the smaller government budget of a small jurisdiction. Political and financial incentives to create (or enter) a legal product market arise when this significant payoff is held out. The incentive relationship lends plausibility in the product market in turn. The small jurisdiction's propensity to fiscal dependence on its legal business provides a structural assurance that customer interests will take precedence over all competing interests in local political deliberations.²⁴⁹

Finally, even though the status sale category shows us that entrepreneurial government actors can exist in practice, there arises no concomitant assurance that incentives respecting status sales will be aligned so as to assure first-best lawmaking. Note first that minimal contacts between the granting state and the customer show up again and again across the examples. Externalization thus emerges as a fundamental supply side motive, which in turn invites interest group manipulation on the demand side. Corporate law shows how such a distortive incentive structure can operate. The locational decision is remitted to one interested group, corporate management, while the statutory structure

²⁴⁹ ROMANO, *supra* note 37, at 6-12. But even given such a clear-cut incentive in favor the interests of a given customer, integration with the rest of the federal system can create complications. For instance, where enforcement is through private lawsuits, states do not fully control their product because parties are free to sue elsewhere. See Hay, *supra* note - 41, at 652. In the corporate law context, this incident of federalism has complicated Delaware's incentive picture. It must offer the plaintiff's bar sufficient returns to induce litigation in the state while simultaneously maintaining a reputation for privileging the interests of management. See Bratton & McCahery, *supra* note 232, at 1898-1900.

excludes from the political decisionmaking process another group with a conflicting interest, corporate shareholders.²⁵⁰ As a result, rent incentives on the supply side are tied to management's interest on the demand side. Juridical path dependencies and collective action problems prevent the shareholders from exploiting any opportunities to register their influence on the law of any of the fifty available jurisdictions so as to make the competitive system work for their benefit. The result is regulatory capture constituted by a competitively-driven lawmaking system.²⁵¹ Since management's preferences vastly outweigh those of the shareholders in the resulting legal regime, it is suboptimal in the evaluations of most observers.²⁵²

2. *Competition for Citizens, Factors of Production, and Capital*

— Competitive regulation also can result from interactions between regulators and actors in product markets. The clearest case occurs when rent-seeking government actors (or private actors in a position to influence those in government) seek to attract mobile factors of production or capital, offering investment-specific tax breaks or subsidies.²⁵³ A more subtle case occurs when the regulatory profiles of alternative jurisdictions figure into the locational deci-

²⁵⁰ The first public choice analysis of charter competition is Macey & Miller, *supra* note 248. See also Butler & Macey, *supra* note 74 at 679 (arguing that what appears to be federal-state competition for bank charters is rent-seeking).

²⁵¹ Bratton & McCahery, *supra* note 232. See also James D. Cox, *Regulatory Competition in Securities Markets: An Approach for Reconciling Japanese and United States Disclosure Philosophies*, 16 HASTINGS INT'L & COMP. L. REV. 149, 164-66 (1993) (warning that international competition respecting securities registration could follow only from the utility functions of managers, and will be desirable only if it operates so as to benefit the interests of the issuer as a whole).

²⁵² For the proposition that the state's responsiveness to the management interest refutes any race-to-the-top claim for the system, see, e.g., Ralph Winter, *The Race for the Top Revisited: A Comment on Eisenberg*, 89 COLUM L. REV. 1526, 1528 (1989); EASTERBROOK AND FISCHER, *supra* note 130, at 222.

²⁵³ It should not be assumed that such competition is upward directed. Leon Taylor, *Infrastructural Competition among Jurisdictions*, 49 J. PUB. ECON. 241 (1992), presents a model in which jurisdictions compete to attract a big-ticket plant project by investing in new infrastructure. Under the assumptions of Taylor's model, the contest involves net waste that might be mitigated by central planning. *Id.* at 251-52. Taylor stresses limitations on the result — waste should be expected where the contest is long, involves a lot of contestants, and the infrastructure has limited alternative uses. *Id.* Taylor also points out that existing literature on regulatory competition for industry assumes that the contest itself consumes no resources. *Id.* at 242. See also Enrich, *supra* note 231.

sions of mobile actors.²⁵⁴ Jurisdictional differentials in environmental regulation give rise to a case often discussed. Today large firms can choose among not only states but nation states when they invest in new plants. As between two potential venues, the one with less restrictive environmental regulation may present a more desirable location from a cost point of view. It follows that capital mobility can put a jurisdiction to a choice between absorbing the environmental costs of production and attracting investment and the alternative of satisfying a preference for a clean environment by charging environmental costs to producers and sacrificing capital investment. As a result, competition for capital much influences the shape of discussions about environmental law, and has influenced the shape of environmental regulation.

Capital mobility also is said to influence other regulatory choices.²⁵⁵ Secur-

²⁵⁴ In core cases of regulatory competition, competition for individuals, factors, or capital either determines the shape of a legal regime or prompts pressure for its reform. A conceptually related class of legal conflicts arises when a legal regime that is not determined by regulatory competition has consequences for producers or consumers in a competitive product market that operates across jurisdictional lines. For example, differentials in environmental regulation that impact on the competitiveness of local businesses have led to disputes in international trade law. Producers in states with less restrictive environmental regulation get a cost advantage over producers in a more restrictive state; the disadvantaged producers, if they cannot secure a relaxation of local regulation, seek retaliatory sanctions against imports from the less restrictive states. Viewed from the perspective of the more restrictive state's lawmakers and producers, such a sanction is a competitive lawmaking response. But it is anticompetitive when viewed from the perspective of the goods market and its consumers, and may run afoul of an international trade law regime. More generally, differentials in environmental regulation have been stumbling blocks in the negotiation and ratification of liberalizing international trade regimes.

Trade law seeks to reduce distortions that result from regulatory competition. Tariffs, quotas and direct subsidies to export industries all seek to enhance the competitiveness of local producers, but nevertheless prohibited under the Treaty of Rome, 2 B.D.I.E.L. 45, GATT, 55 U.N.T.S. 187, and NAFTA, 32 I.L.M. 605 (1993). There is a trade law argument that defends retaliatory sanctions that make up for differentials in environmental regulation that significantly lower the costs of producers in a less strict regime: The less strict state's regulatory laxity amounts to a production subsidy. This 'indirect subsidization' idea has been the justificatory basis for retaliatory sanctions, by the US, but has not succeeded. *See* United States — Restrictions on Imports of Tuna, 30 I.L.M. 1594, (1991); United States — Restrictions on Imports of Tuna, DS29R, June 1994. For discussion of these matters, *see* Howse & Trebilcock, *supra* note 12.

²⁵⁵ International tax competition presents the case of maximum mobility. Multinational corporations have proved adept at using internal transfer pricing to shift income to lower tax venues, avoiding the cost of physically shifting operations. After Britain and the United

ities regulation is one area of discussion. Capital for a given financing may be on offer in a number of competing centers worldwide. If investment institutions sited in one of these centers find their freedom of action limited by local securities or investment laws and lose business to foreign firms and capital markets, they will, in turn, argue that this international competition justifies relaxation of the local constraint. Some of these deregulatory initiatives have prompted changes in domestic securities regulation; others have not.²⁵⁶

All of the frictions that inhibit the appearance and impact of competition in local public goods situations potentially can come to bear on cases in this broad, open category of regulatory competition. Competition, accordingly, cannot be assumed. Even the presence of policy discussions about competition does not assure its actual presence. For example, it is not clear that the oft-discussed tie between competition for capital and environmental regulation actually influences real world locational choices. It recently has been shown that environmental regulations do not have a statistically significant effect on plant location decisions.²⁵⁷

The degree to which frictions come to bear will vary with the particular subject matter. The following discussion makes some observations about structural tendencies. It begins with externalities, showing how the framework of analysis of the tax competition models has been applied to competition for environmental regulation to show a theoretical possibility of distortive results. The discussion goes on to the problems of optimal numbers, mobility, information, and entrepreneurial incentives.

a. Externalities and Competitive Environmental Policy

— The tax competition literature's influence in legal contexts should not be cabined to tax policy discussions. Interconnections among all aspects of state

States cut corporate rates during the 1980s, Canada felt impelled to follow suit lest its corporate taxpayers use paper ruses to shift income out of the country. See Robert A. Green, *The Future of Source-Based Taxation of the Income of Multinational Enterprises*, 79 CORNELL L. REV. 18, 62 (1993).

²⁵⁶ In the United States, the Securities and Exchange Commission has taken limited steps to facilitate cross-border financing and securities transactions. See Regulation S, Securities Act Release No. 33-6863 (Apr. 24, 1990); Rule 15a-6 under the Securities Exchange Act, 17 C.F.R. §240.15a-6 (1989); Rule 144A, 17 C.F.R. § 230.144A (1992). But, with the exception of Canadian firms, see Securities Act Release No. 33-6902 (June 21, 1991), the SEC has refused to accord mutual recognition home country auditing standards and accounting principles of foreign issuers.

²⁵⁷ See Adam B. Jaffe, et al., *Environmental Regulation and the Competitiveness of U.S. Manufacturing: What Does the Evidence Tell Us?*, 33 J. ECON. LIT. 132 (1995).

fiscal policy make these models' learning pertinent across the regulatory competition debates. Tax policy, for example, can be influenced by policies respecting investment and employment, and those policies in turn can influence levels of regulation. A model that shows tax rates being set suboptimally in a myopic attempt to attract capital thus can be extended to include tradeoffs made respecting labor and environmental standards and capital investment. It thus comes as no surprise that a tax competition model already has taken a lead role in the federalism debate in the environmental law field.

The model is the Oates-Schwab model of environmental law competition. As is well known, this model has been commended as a theoretical base point for a devolutionary legal policy.²⁵⁸ It is less well known that the model's outcomes depend entirely on assumptions it makes respecting tax policy. Indeed, with the help of a recent extension by Wilson,²⁵⁹ the Oates-Schwab model shows us that fiscal effects of state-based environmental regulation create a structural possibility of inefficiency whenever the regulating state comes to the table with a suboptimally constructed tax regime. The model thereby teaches us an important lesson about the appropriate concept of environmental externalities. Although all legal discussants concede that interstate environmental externalities justify federal regulation, they tend to think in strictly physical terms in so doing, with cross-border pollution emerging as the primary policy problem. The Oates-Schwab model shows this conception to be unduly restrictive — fiscal externalities also need to be considered. There follows a more particular description of the connection.²⁶⁰

Economic theory tells us that firms should pay taxes equal to the costs of the public goods they consume plus the external costs imposed by their activities. Thus do tax levels become connected to environmental regulation: In theory, a polluting firm can be taxed in the amount of the cost of its pollution, with the public goods thereby financed being returned to the citizenry as compensation for the pollution. Predictably, the Tiebout literature asserts that competition will force this tax to be set at the right level — firm mobility will prevent competing states from imposing a pollution tax greater than pollution cost;

²⁵⁸ See *supra* note 162.

²⁵⁹ Wilson, *supra* note 162, at 393-427. Wilson is a principal contributor to the tax competition literature. See John Douglas Wilson, *A Theory of Interregional Tax Competition*, 19 J. URBAN ECON. 356 (1986).

²⁶⁰ See A.L. Bovenberg & F. van der Ploeg, *Environmental Policy, Public Finance and the Labour Market in a Second-Best World*, 55 J. PUB. ECON. 349 (1994) (modelling environmental and tax policy tradeoffs on realistic tax assumptions and getting second-best results).

local zoning regulation will assure that firms do not underpay.²⁶¹ The Oates-Schwab model takes this a step farther, showing that a regime of environmental controls can provide a functional substitute for such a regime of pollution and taxation. Taking a cue from the tax models, Oates-Schwab has the cost-benefit tradeoff occur with the capitalization of the cost of the regulations. More particularly, instead of paying tax in exchange for the right to pollute, firms operate under environmental controls that tie the right to pollute to the hiring of additional units of labor. The model assumes that the supply of labor is fixed,²⁶² and that the states tax labor but not capital. Given these assumptions, payment for the emissions comes not in the form of public goods financed by taxes but in the form of higher wages for factors supplied by residents. At the bottom line, then, each jurisdiction's residents have an incentive to cause emissions to be reduced to the point where the marginal value they place on a cleaner environment equals the marginal loss in output and employment.²⁶³ The states sort themselves out in accord with their relative preferences for pollution and wages.²⁶⁴

Wilson shows that land may be substituted for labor as the fixed factor in Oates-Schwab. Given land use controls, a higher permitted level of emissions results in higher land rents. This switch to a land-based model makes it easier to imagine a tax externality. The neat trade off between emissions and rents works only to the extent that all rent recipients live in the jurisdiction. With significant absentee land ownership this will not be the case. The absentees will favor inefficiently lax standards, while the residents will prefer inefficiently strict standards, exporting the cost to the absentees. The actual result will depend on the jurisdiction's political equilibrium.²⁶⁵

The Oates-Schwab model similarly incorporates the possibility of a suboptimally lax environmental regime when it introduces a tax on capital while

²⁶¹ Wilson, *supra* note 162, at 394, 400. The leading models are Fischel, *supra* note 17, and Hamilton, *supra* note 102.

²⁶² Cf. Wilson, *supra* note 162 (fixed supply of capital in model of tax competition).

²⁶³ Oates & Schwab, *supra* note 73, at 335; Wilson, *supra* note 162, at 403-405.

²⁶⁴ Wilson points out that this best result depends on the assumption of a fixed labor supply. A different result obtains if an upward-slope in the labor supply curve is assumed. Now the regulatory link between emissions levels and employment amounts to a distortionary subsidy to labor. To reduce the subsidy, the permitted amount of emissions has to be decreased to an inefficiently low amount. The result is a NIMBY situation — a suboptimally strict environmental regime. *Id.* at 405.

²⁶⁵ *Id.* at 406-7. Here Wilson parallels the Oates-Schwab discussion of political conflict between blue collar and white collar residents. Oates & Schwab, *supra* note 73, at 338.

leaving environmental regulation tied to inputs of a fixed supply of labor. Unlike the supply of labor, the supply of capital is not fixed in the model. The result is that stricter emission standards cause a reduction in capital supply, which has the indirect effect of reducing tax revenues. The cost of stricter emissions controls now exceeds the jurisdiction's willingness to pay. Given interstate competition for capital, the result is a race to relax environmental standards in order to attract capital.²⁶⁶ But, adds Wilson, that result is avoided if we adjust the model so as to tie permissible emissions to capital supply rather than labor supply. If capital is taxed at a rate equal to the environmental cost of an additional unit of capital, efficient emissions regulation reemerges. On the other hand, if the capital tax rate is set higher than the environmental (and other) costs to the jurisdiction of the investment, then we are thrown back into a suboptimal competitive situation. Capital outflows occur, and governments wishing to make up the loss in the tax base lower environmental standards as they attempt to increase the capital supply. Contrariwise, if capital is taxed at an inefficiently low rate — that is, the tax yields less than the environmental and other costs incurred in the jurisdiction — there results a propensity toward inefficiently high standards, the NIMBY effect.²⁶⁷

Expanding further, Wilson asserts that, as a general proposition, environmental regulation should not be used as an instrument for attracting capital into the jurisdiction. Subsidies and tax reductions present lower cost means to this end than do environmental standards that fall below those for which citizens otherwise are willing to pay. But, to the extent that jurisdictions adopt sub-optimal capital taxation regimes, they are likely to turn to environmental policy as a way to influence investment levels.²⁶⁸ And, unfortunately, jurisdictions have many incentives to tax capital suboptimally. Capital tax levels may be skewed due to their relation to employment levels.²⁶⁹ In the alternative, high transaction costs related to the collection of a capital tax may cause the substitution of environmental policy as a mechanism for influencing investment.²⁷⁰

Significantly, at no point does this discussion make a general prediction of a downward directed results. Nor, for that matter, does it generally predict upward directed results. The point instead is that we possess neither a theoretical nor empirical basis for either prediction. What is needed, says Wilson, is

²⁶⁶ Oates & Schwab, *supra* note __, at __; Wilson, *supra* note __, at 407.

²⁶⁷ *Id.* at 408.

²⁶⁸ *Id.* at 409.

²⁶⁹ *Id.* at 413-15.

²⁷⁰ *Id.* at 411-13.

research that enhances our understanding of the incentives that cause governments to substitute environmental policy for more effective fiscal tools. And, he says, the key lies in better understanding of 'political market failures'.²⁷¹

b. Optimal numbers

— On the surface, optimal numbers are less of a concern with regulation than with public goods, since words on a page do not present the same scale economy problems as do the production of goods and services such as streets and education. But, on reflection, concerns respecting scale economies are not absent. The most prominent line of questions respecting competitive decentralization concern regulatory conventions — expected regularities of behavior such as the rules of the road.²⁷² These perform a coordinating function analogous to that performed by the taxing sovereign who provides traditional public goods. Any one of a range of behaviors may be equally rational, but costs will be saved if a means can be found to select one behavior pattern in the range. With the rules of the road, uniformity saves accident costs. With standardized default rules for contracting parties, uniformity economizes on the transaction costs of search, verification, and coordination.²⁷³ The same thing can be true for regulation. With product specifications, diversity across jurisdictions can increase transaction costs of compliance by foreign producers or, worse, amount to a form of protectionism; harmonization can bring scale economies and increased competition.²⁷⁴ Thus, given trade and mobile factors and capital, cost minimization requires horizontal units to operate together as a juridical system to some extent. Decentralization looking to the benefits of competition will become suboptimal at the point where the number of resulting jurisdictions is so large that diversity begins to entail net costs.

Advocates of maximal decentralization have a standard response to this line of analysis. With regulation (unlike public goods production in geographically bounded political subdivisions) a plausible spontaneous order story can be told. Efficient local legal regimes can evolve on a trial and error basis at a local level without the necessity of central adjustments for the purpose of harmoniz-

²⁷¹ *Id.* at 396, 408. It should be noted that Wilson suggests several models and avenues of inquiry in addition to those mentioned here. In any event, this the theoretical result tracks the detailed responses to Revesz, *supra* note 10, in the environmental law literature. See Esty, *supra* note 144, at 638-51; Swire, *supra* note 62, at 94.

²⁷² DAVID LEWIS, CONVENTION (1969).

²⁷³ Charny, *supra* note 70, at 443-44.

²⁷⁴ Stewart III, *supra* note 33, at 2043-44. See also Esty, *supra* note 144, at 613-23 (showing how technical complexities implicated in environmental regulation make state regulation unfeasible).

ation. The market can set the balance between regulatory diversity and harmonization. Mobile capital and factors of production will gravitate to the jurisdictions with the best rules; those rules, having thus risen to the top, then will serve as focal points for other jurisdictions, which will imitate them.²⁷⁵ Harmonization results on a bottom-up rather than a top down basis.²⁷⁶

Given complete capital and factor mobility, intense competitive pressures, and stable equilibria, evolutionary processes very well might produce the cost-beneficial regime envisaged. But suppose these assumptions are not safe. If, in practice, citizen, factor, and capital mobility and competitive pressures on regulators are sporadic and vary in intensity with different subject matter, then costly diversity can persist over time. Given this deadweight cost, centralized coordination to provide a uniform set of standards — default rules or mandates, depending on the subject matter — would economize on transaction costs.²⁷⁷ In sum, any guarantee that junior level regulation assures an optimal degree of uniformity respecting regulation, depends on the safety of the other assumptions the Tiebout model makes.

c. Mobility

— Once again the question goes to the particular mobile actor or factor sought by jurisdiction and the cost involved. Competition for residents, for example, is more likely to show up among localities within a state or states within a federation than among nation states. There is a trend towards greater international labor mobility, but its level is often overstated.²⁷⁸ Movement of labor between countries remains too small to have much economic significance.²⁷⁹ The upshot of this discussion is a notion of differential mobility: In advanced

²⁷⁵ Cf. Krauss, *supra* note 115, at 786-96 (describing emergence of spontaneous order emerges as dominant strategy in repeated 'crossroads' game); Klausner, *supra* note 115, at 848 (firms have incentives to produce products compatible with a dominant product and will imitate).

²⁷⁶ The corporate law system provides an example of this process. See William W. Bratton, *Corporate Law's Race to Nowhere in Particular*, 44 U. TORONTO L.J. 401 (1994); William J. Carney, *Federalism and Corporate Law: A Non-Delaware View of the Results of Competition*, in INT'L REGULATORY COMPETITION, *supra* note 70, at 153.

²⁷⁷ Charny, *supra* note 70, at 436-37. Cf. Larry E. Ribstein & Bruce H. Kobayashi, *An Economic Analysis of Uniform State Laws*, 25 J. LEG. STUD. 131, 132 (1996), which studies adoption patterns of uniform state laws and concludes, based on an exogenous and informal concept of efficiency, that a combination of jurisdictional competition and interest group politics causes higher adoption rates of efficient statutes.

²⁷⁸ Woolcock, *supra* note 101, at 301.

²⁷⁹ KRUGMAN II, *supra* note 97, at 181.

economies, capital's mobility will exceed that of labor, particularly across national borders, and the mobility of financial capital and capital for new producing investments will exceed that of capital already invested in hard assets or locationally situated through ties of goodwill.²⁸⁰ Incidences of regulatory competition will reflect the differentials. We are unlikely to see competition for residents across national borders along the lines predicted by Tiebout's model of government. Instead, as we apparently have begun to see in the area of securities regulation, national regulators will be forced to compete to offer low-cost regulatory products to highly mobile factors.²⁸¹ In effect, immobile factors of production — individuals in different countries or locations — will be competing for the only really mobile factors, capital and technology.²⁸²

At the state and local level, higher relative mobility for capital and technology may skew the appearance of jurisdictional competition in a direction quite different from that predicted by the Tiebout model. Given a weak mobility constraint on government actors, local public goods production may proceed relatively uninfluenced by market constraints. Simultaneously, tax policy and industrial regulation could be heavily influenced as government actors chase capital investment.²⁸³

d. Information

— The problem of asymmetric information will be ameliorated on the demand side in some regulatory competition situations by the appearance of intermediaries who, given demand for information, will appear to collect and channel it to consumers for a fee. One suspects that for Tiebout's relocating individuals the information asymmetry problem is ameliorated only in a small degree by networks of real estate agents. But, with a shift of the subject matter to competition for regulatory goods across states and nations, the profiles of informational intermediaries become more pronounced. We have seen that lawyers and investment bankers disseminate information about corporate law across the 50 states. Similarly, large law firms provide the comparative expertise necessary for consumer choice among regulatory regimes within the

²⁸⁰ See Shaviro, *supra* note 44 at 964; Green, *supra* note 255 at 57-58.

²⁸¹ See Cox, *supra* note 251. But even here in this most fluid of international situations, a number of factors seem to be keeping capital tied to home markets. See Perry, *supra* note 34, at 708 (citing tax policy, the issuer's desire for a public profile, administrative costs, and domestic market efficiency in accounting for fact that American companies still tend to raise equity capital at home).

²⁸² Woolcock, *supra* note 101, at 306.

²⁸³ BRETON, *supra* note 57, at 192.

50 states and internationally.²⁸⁴ Since these lawyers will be consulted by both sellers and buyers of regulation and will themselves move in and out of government, their intermediary role will be far from passive. But they may very well solve any serious problems of information availability respecting regulation (if not of information cost). Generally, then, as the scale of regulatory consumer choice expands from the local and mundane to the far ranging and grand — from the choices to individuals to the choices of those who manage capital — information asymmetries become less of a problem.

One other information problem should be mentioned, this one on the supply side. Law production results from deliberative, political processes. As we saw with the tax competition models,²⁸⁵ if asymmetrical information exists amongst competing lawmakers, or one set of regulators fails properly to account for the choices of another,²⁸⁶ no equilibrium matching of regulation and preferences will result. Alternatively, one jurisdiction may inaccurately predict the tradeoff calculus prevailing in another, setting its regulatory standard lower (or higher) than necessary.²⁸⁷ Later development of a full set of information will at least create an opportunity for a cure, provided that other factors remain relatively stable. Given keen competitive forces, neither interest group deals nor political stasis should get in the way of an adjustment. Relative stakes should be pertinent once again: The greater the capital investment riding on a particular regulation, the less of a problem information asymmetries should present.

e. Entrepreneurial Incentives and Regulatory Capture

— As with local public goods, credible predictions of beneficial regulatory competition require sustained attention to supply and demand side incentives.²⁸⁸ Compare once again the situation of a conventional producer

²⁸⁴ Yves Dezalay, *Between the State, Law and the Market: The Social and Professional Stakes in the Construction and Definition of a Regulatory Arena*, in INT'L REGULATORY COMPETITION, *supra* note 70, at 59.

²⁸⁵ See *supra* text accompanying note 162.

²⁸⁶ Majone I, *supra* note 69, at 24. See also Bewley, *supra* note 84, at 720. International tax competition has been described as an area of perverse effects resulting from failings of technical understanding on the part of taxing authorities. According to Green, *supra* note 255, at 59-60, manipulation of source-based corporate tax systems leads to competition, but not a competition related to levels of public goods production.

²⁸⁷ Stewart III, *supra* note 33, at 2059.

²⁸⁸ Indeed, even though the Tiebout model does not make this demand, such attention has been the practice of many legal scholars. Discussions of regulatory competition respecting product standards and product liability are distinguished for the care they take to include

of private goods to that of a regulator. In conventional product markets, cost-benefit calculations on both the supply and demand side focus on the price and quality of a single product and result in the consummation or rejection of a two-party transaction. With regulation, in contrast, the product's welfare effects often present complex conflicts of interest. If, for example, the regulation is a new environmental control, government actors must consider welfare effects on all constituents of polluting firms resident in the jurisdiction, in addition to effects on the firms themselves and on the residents who do (and do not) bear the cost of the pollution. Differential effects present problems of preference aggregation and difficult political calculations. The rent-incentives, electoral interests, and welfare concepts of multiple actors are implicated. In addition, bundles of issues may become tied together in the decisionmaking process.²⁸⁹

There results a problem of winners and losers. The lawmaker's preference aggregation problem will not necessarily admit of a neat solution. Some affected actors may be dissatisfied with the regulatory result, whether or not competitively determined. The theory remits the losers to self-protection through relocation to a more satisfactory jurisdiction. In the environmental law example, where regulation is enacted, polluting firms must disinvest and reinvest elsewhere; where regulation is not enacted pollution sensitive individuals must move somewhere with a stricter code. The problem is that the technical possibility of *ex post* exit does not solve the lawmaker's *ex ante* preference aggregation problem. Given bundled regulatory products, information asymmetries, associational ties, cultural preferences, and the costs of

consideration of probable lawmaker incentives. The earliest such model is Rice, *supra* note 25, at 56-60, which projects a race by the states toward stricter product standards than they otherwise would prefer. The ultimate cause is the product manufacturers' inability to design and price to reflect differentials between the laws of more and less strict states. In Rice's model, legislative movement toward stricter standards is sparked by a class of disadvantaged merchants. Solmine, *supra* note 41, at 72-73, backs up McConnell, *supra* note 41, on suboptimal product liability litigation, with an interest group story. State supreme court judges, says Solmine, are not fully insulated from interest group pressure. Finally, Hay, *supra* note 41, at 617-18, 651-52, rebuts McConnell by arguing that the states' pro-plaintiff conflicts rules give them room to make their own liability rules less stringent, thus favoring their own manufacturers.

The credibility of any of these projections can be questioned. The point is that when they are included the black box is opened and chances for evolution of an accurate description are enhanced.

²⁸⁹ Information problems also may inhibit preference sorting in the environmental area. See Esty, *supra* note 144, at 631.

movement, exit will not be a viable option for all dissatisfied parties.

There also remains a possibility of regulatory capture. Given the frictions, the presence of junior-level competition does not guarantee that the political process of trading off preferences and policies operates as a Pareto superior preference matching mechanism. To see this, return to the environmental law example and draw an analogy to the result with competitive corporate law.²⁹⁰ By analogy to the case of corporate law, interest groups favoring pollution could effectively organize themselves so as to capture regulators throughout the class of jurisdictional alternatives so that the list of clean air alternatives dwindles to the point at which the regulatory decision might as well have been made by the central government. On this scenario, the dissatisfied parties do not even have exit available as a possibility. Given differential mobility, nothing in the competition model prevents this result.

More generally, if a complex of variables connects competition and product quality, then the outcomes predicted in regulatory competition models will have to be stated in relative terms. Given qualified predictions, the evaluation of present or projected regimes of competitive lawmaking may come to turn on descriptions of the institutional contexts in which competition influences lawmaking,²⁹¹ and closer attention to distortions stemming from interest group politics.

V. CONCLUSION

The economics of jurisdictional competition have followed a standard social science pattern during their four decade history. After a confident start, ordinary testing and criticism has led to retrenchment. A tentative theory emerges today. It is still heavily couched in enervating assumptions, while empirical confirmations remain suggestive only. Actors in the field, dissatisfied with the construct, experiment with improvements and alternative means to the same end. Legal federalism should take the economics on its own terms. This means a plausible case for a competitive solution to a regulatory problem requires a situation-specific demonstration both of projected beneficial effects and the absence of perverse effects identified in the economic literature. Lawyerly presumptions have no place.

²⁹⁰ See *supra* text accompanying note 250.

²⁹¹ Cf. JULES L. COLEMAN, RISKS AND WRONGS 61 (1992).

Our claim that legal federalism does not reflect the terms, implications, and problematics of the formal economics on which it draws gives rise to an institutional question. Given the competitive and critical nature of academic discourse, why such a long wait for an arbitrage corrective to this situation of interdisciplinary information asymmetry? We answer by analogy to the literature on efficient markets, which teaches that informationally efficient results depend on the presence of an appropriate incentive structure.²⁹² Simply, law and economics are not incentive compatible, at least in this case.

Several factors explain the absence of incentives favoring thorough arbitrage from public economics.²⁹³ Some of these are particular to the context. For example, legal jurisdictional competition is a disaggregated discussion. Applications and critical responses occur in separate, well-defined subject matter categories — local government and land use, corporate, environmental, products liability, trade, and so forth. The subject matter divisions amount to natural barriers to the circulation of information. Local government and property law are the only applications with strong subject matter affinities to public economics. Unsurprisingly, these discussions tend to be better informed. In addition, the sharpest criticisms of the theory have followed from a race-to-the-bottom perspective. This means that they pursue the position that competition is an intrinsically illegitimate influence on regulation, even as they share a number of assumptions respecting the presence and effects of competition with the theory's proponents. A race-to-the-bottom proponent has little incentive to look to the parent economics for useful ideas.

Broader structural disincentives also should be mentioned. Interdisciplinary legal discourses do not necessarily replicate the critical incentive structures of the natural and social sciences. We suspect, for example, that because legal scholarship is normative — that is, it tends to be directed more to the support of policy positions than to accurate description — it favors simpler (and often older) economic models that signal clear bottom-line results. We also suspect that reputational payoffs tend to favor an initial arbitrage of a particular

²⁹² Few any longer contend that securities markets are strong form efficient — if all relevant information already is incorporated into market prices, then no one has a financial incentive to invest in acquisition of new information. If, however, prices only partially reflect the information level of the best-informed trader, the requisite incentives find a place in the description. See Grossman & Stiglitz, *On the Impossibility of Informationally Efficient Markets*, 70 AMER. ECON. REV. 393 (1980).

²⁹³ The problem also may be derivative. See Rose-Ackerman, *supra* note 73, at 333, commenting that 'the lessons of theoretical economics have not been well assimilated by urban economists' in the Tiebout mold.

economic theory over a maintenance exercise that marginally enriches a well-established interdisciplinary discourse. Indeed, to the extent that a maintenance exercise casts doubt on an established policy position supported by an outdated economics, reputational disincentives may outweigh incentives. There also may be a numbers problem. The number of legal scholars applying economics is much larger than the number of trained economists producing legal scholarship. As an economics becomes more complex, the number of potential observers with an incentive to maintain the information level of the legal literature becomes smaller. But, as this Article shows, corrective incentives are not wholly absent in the legal context.

CHAPTER 6

AN INQUIRY INTO THE EFFICIENCY OF THE LIMITED LIABILITY COMPANY: OF THEORY OF THE FIRM AND REGULATORY COMPETITION*

6.1 Introduction

In an ideal world, inquiry into the efficiency of a legal regime would mean the collection and analysis of empirical information concerning costs and benefits. But, due to cost constraints and limits on available means of measurement,¹ fact studies are the exception rather than the rule in law and economics. Instead, legal policy debates respecting efficiency usually deploy economic theories in the absence of determinative empirical evidence. Efficiency emerges not as fact but as presumption. For, absent data on costs and benefits, these debates must be resolved through the allocation of an empirical burden of proof, with the party ending up bearing the burden losing the debate. Participants draw on the behavioral predictions of economic theory as they search for ways to assure the burden's placement on their opponents' shoulders.

Economic models, however, do not come ready-made with burden of proof recommendations keyed to legal policy debates. They must be translated and adjusted for legal contexts. Historically, these arbitrage exercises have simplified the economics, so as to cause it to yield clear policy signals, regulatory or deregulatory as the case may be. But with some heavily traversed subject matter, the passage of time has brought such an accumulation of economic assertions as to cause the presumptive regulatory signal to lose its clarity. Such a mature literature, by virtue of its very complexity, is less well-suited to the sustenance of strong policy positions. Policy debates still go forward, of course. But clarity of position follows less from the terms of economic theory itself than from the employment of the ordinary tools of normative lawyerly

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¹ And limitations of training.

debate.

The law and economics of limited liability, with its succession of back-and-forth arguments about the location of an efficiency presumption for and against,² presents a literature of this sort. So when Allan Vestal asked us to inquire into the efficiency implications of the recent proliferation of limited liability company (LLC) statutes for this symposium, we accepted the invitation without making any projection as to the exercise's probable result. But we did harbor a hope that the economic literature, upon *de novo* review, would yield some new theoretical spin on limited liability, a spin that would provide new advice as to the appropriate location of the legal presumption and redirect the back-and-forth legal debate. Unfortunately, that hope was not fulfilled. The economics we reviewed does indeed offer new theoretical perspectives on limited liability. But, instead of sending a new efficiency signal, these only further complicate the existing picture. We emerge to find ourselves in a position to recommend only that the best presumption is that the present economics supports no presumption at all.

This article reports on our encounter with the economics of limited liability. It begins, in part I, with a review of the back-and-forth debate on limited liability in law and economics and of applications of positions in that debate to the LLC. Here we observe that the proponents of the LLC have grounded their claims for productivity-enhancement on an extremely thin theoretical base. Their claims follow the view, first articulated more than a decade ago, that limited liability fosters efficiency because it lowers the cost of shareholder monitoring, reduces the risk of investment, and creates conditions for the free transferability of shares. This is said to permit shareholder portfolio diversification which in turn is said to prompt more productive investment policies within firms. The thinness of the view becomes apparent when reference is made to a contrasting law and economics theory, the pro rata hypothesis. This asserts that the problems of unlimited liability can be solved if a pro rata liability regime is employed in place of the joint and several regime manifested in current partnership law. It projects that, given that pro rata regime, efficiency gains will follow from stepped up equityholder incentives to limit firms' suboptimal risky investments. This pro rata view directly and strongly challenges all standing justifications for limited liability for small firms. It is, accordingly, somewhat surprising that LLC proponents thus far have failed to address it.

² See *infra* notes 3-34 and accompanying text.

Part I goes on to report on our encounter with the economic literature. Here we claim that the story about capital and ownership structure drawn on heretofore to claim efficiency effects for limited liability no longer safely can be relied on as a matter of economic theory. We show that the most basic notion behind that efficiency case — that there is an interesting connection between a single firm ownership structure and the maximization of firm value — has become highly contestible. It may be unsafe, in the absence of empirical verification, to assume that there is any direct relationship at all between a particular ownership structure and firm performance. More specifically, some models show that an incentive device (such as collateral) can provide a sufficient economic basis to align management incentives and limit the effects of risky decisions. Other models show that under certain conditions concentrated shareholding may have productivity advantages. Cumulated, these presentations sharply controvert the assertion that limited liability enhances productivity by discouraging concentration and encouraging diversification. Part I, in its final segment, considers the implications of the assumption, made by both the efficiency and pro rata approaches, that insurance is readily available cover the risks taken by firms. Here we ask some questions about this assumption's safety, making reference to some recent literature on insurance's availability and effect.

In part II we take up the second component of the LLC proponents' efficiency case — the assertion that the economic theory of regulatory competition comes to bear to justify the states' seriatim adoption of LLC statutes. Here, in contrast to part I, we emerge from our encounter the economics with a definite result. We assert as a general proposition that regulatory competition analysis cannot plausibly be conducted on a black box basis that avoids inquiry into the incentives of government actors. We use this perspective to show that, although LLCs do present a law as product situation, the classic race-to-the-top story in which fifty states compete to supply cost-saving business forms to an undifferentiated class of choosey consumers does not fit the facts of the case. A more plausible economic account of the enactment of LLC statutes centers on a locally-based supply and demand description and an interest group causation story. Given such an account, regulatory competition theory provides no basis for an efficiency pronouncement in favor of the LLC. But we also show that it does not thereby imply an affirmative inefficiency story either. We consider and reject the suggestion that the LLC amounts to a race-to-the-bottom, finding the application of the downward model of regulatory competition in this case to be just as implausible as the application of the upward, race-to-the-top model.

Our regulatory competition analysis thus reaches definite conclusions only to

offer no ultimate help on the question-in-chief — the appropriate location of an efficiency presumption respecting the limited liability company. As to that we make no recommendation.

I. LIMITED LIABILITY AND ECONOMIC EFFICIENCY

We begin this part of this essay with a review of the law and economics of limited liability and its application to the LLC. We go on to situate some of the economic concepts operative in this literature in the larger context of the economic theory of the firm. We pursue a modest objective in so doing. We do not, for example, purport to offer either a complete review of the latter literature or a definitive statement of its bearing on the subject of limited liability. We seek instead to show that some of the economic assertions figuring prominently in the legal policy discussion are highly contestable as a matter of economic theory. To the extent that we succeed, we further complicate an already complex discourse.

A. The Limited Liability Company and the Law and Economics of Limited Liability

A limited liability company bandwagon has rolled across the country. Since 1988, when two states provided for this business form,³ forty-six additional states have enacted enabling statutes. Law practice in the field has matured rapidly, aided by a prototype statute from the American Bar Association,⁴ a model act from the Uniform Laws Commissioners,⁵ and a comprehensive Revenue Procedure from the Internal Revenue Service.⁶ All observers agree on a simple explanation for this spontaneous expansion of the menu of business forms: There is high demand for the LLC's combination of one-tier, partnership tax treatment,⁷ limited liability, and flexibility respecting governance

³ We use the word 'new' guardedly. As William Carney has shown, the LLC is a first cousin of the historical joint stock company. William J. Carney *Limited Liability Companies: Origins and Antecedents*, 66 U. COLO. L. REV. 855, 868-77 (1995).

⁴ PROTOTYPE LTD. LIAB. CO. ACT (American Bar Association 1992).

⁵ UNIF. LTD. LIAB. CO. ACT (1995). For criticism of this statute, see Larry E. Ribstein and Bruce H. Kobayashi, *Uniform Laws, Model Laws and Limited Liability Companies*, 66 U. COLO. L. REV. 947 (1995).

⁶ Rev. Proc. 95-10, 1995-3 I.R.B. 20.

⁷ The Internal Revenue Service's 1988 determination to accord flow through tax treatment, Rev. Rul. 88-76, 1988-2 C.B. 360, is a *sine qua non*. See Larry E. Ribstein, *The Emergence of the Limited Liability Company*, 51 BUS. LAW. 1, 4 (1995), hereafter cited

terms.⁸ The menu's antecedent means to the same end — the Subchapter S Corporation and the limited partnership — now appear in comparison to implicate excess complexity and, accordingly, excess cost.⁹

The LLC's proliferation improves the menu of business forms in several ways. It brings us to the final stage in the evolutionary abandonment of the historical association of, on the one hand, limited liability, corporate governance norms, and two-tier tax treatment, and, on the other hand, unlimited liability, partnership governance norms, and one-tier tax treatment. The substantive grounds that justified the bundling of the former trio lost their force many years ago when limited liability, quasi-partnership governance norms, and one-tier tax treatment became available to actors who elected Subchapter S status and made full use of close corporation provisions in state codes. By the logic of legal coherence, that concession of half-a-loaf implies a further concession of the whole. One-tier tax treatment with limited liability having been made available to those willing to pay the freight of the extra layer of transaction costs incurred in organizing a close corporation, it appears arbitrary, even undemo-

as *Ribstein I*.

⁸ LLC statutes tend to allow members to choose between centralized and direct member management.

⁹ Limitation of liability through the limited partnership form presupposes barriers to the exercise of control by those participants enjoying the benefit of limited liability. See REV. UNIF. LTD. PART. ACT §303 (1976).

The corporate form does not require such an arrangement. As is well known, parties may incorporate and adopt special provisions that approximate the terms of partnership governance, such as management at the shareholder level, restrictions on transfer of stock, and exit through buyout or dissolution. Single-tier tax treatment then can be achieved under Subchapter S, INTERNAL REVENUE CODE, § 1361 (1988). The popularity of the LLC implies that the complexity of the planning required for employment of these provisions has operated to limit the number of businesses that opt for limited liability. As Ribstein argues, given the imperfections of planning by contract, the background of inappropriate corporate governance norms never recedes from significance. *Ribstein I*, *supra* note 7, at 2-3. The Subchapter S restrictions — as to the number of shareholders, capital structure and ownership interest in subsidiaries, see INTERNAL REVENUE CODE, § 1361(b)(1)(A)-(C) (1988) — also often are included on the list of deterrents. See, e.g., William L. Klein and Eric M. Zolt, *Business Form, Limited Liability, and Tax Regimes: Lurching Toward a Coherent Outcome?* 66 U. COLO. L. REV. 1001 (1995).

Forced to choose between the two disabling factors — state corporate law and federal tax restrictions — we would choose the former. The Subchapter S restrictions do not operate as constraints on many small businesses; but, the smaller the business, the larger the barrier presented by complex planning supervised by an outside legal professional.

cratic,¹⁰ to withhold the benefit from those similarly situated but unwilling to pay.¹¹ Corporate law having abandoned mandatory imposition of its board-level, collective decisionmaking norm without concern for the resulting expansion in the number of firms enjoying limited liability,¹² there appears no compelling reason against an expansion of the menu of governance options available to firms doing business under the shield of limited liability.¹³ The list of factors that in an ideal world would determine, on the one hand, the availability of limited liability and, on the other hand, the application of one- and two-tier tax treatment is unlikely to include the actors' preference for partnership as opposed to corporate governance norms.

Legal coherence, however, provides only a conditional basis for the validating business law practices. Today, they must also be determined efficient. Unsurprisingly, the literature leaves open the empirical question respecting the LLC's costs and benefits, and addresses the matter at a theoretical level. Unfortunately, the applicable theoretical literature takes a divided stance, inviting replication of its back-and-forth arguments as discussion goes forward respecting LLC's presumptive efficiency.

¹⁰ See Stephen B. Presser, *Thwarting the Killing of the Corporation: Limited Liability, Democracy, and Economics*, 87 NW. U. L. REV. 148, 155-56 (1992); Klein and Zoldt, *supra* note 9 at 1030-34.

¹¹ Here we echo the argument of Klein and Zoldt. For them the *status quo* makes no sense as a tax policy proposition. They comment that it is surprising that investors are entitled to elect between two significantly different tax regimes. They also find it peculiar that the participants get to choose whether or not to enjoy limited liability. Klein and Zoldt, *supra* note 9, at 1002. While the wisdom of the provision of limited liability may be debatable, it is their view that there is no reason why the liability shield be connected to the choice of business form or the tax shield. *Id.* at 1007. We agree. Klein and Zoldt provide an excellent analysis of the tax policy issues implicated by LLCs. *See id.* at 1006-1007.

¹² Ian Ayres, *Judging Close Corporations in the Age of Statutes*, 70 WASH. U. L. Q. 365, 378-88 (1992), recounts this history.

¹³ See Jonathan R. Macey, *The Limited Liability Company: Lessons for Corporate Law*, 73 WASH. U. L. Q. 433, 451-52 (1995) (noting that theoretical questions about tort externalities have not entered in the political processes that have produced LLC statutes); *cf.* Larry E. Ribstein, *Limited Liability and Theories of the Corporation*, 50 MD. L. REV. 80, 92-93 (1991), *hereafter cited as Ribstein II* (arguing that corporate law process mandates serve a function similar to that of the control rule applying to limited partnerships in discouraging use of the limited liability form of doing business).

1. *Efficiency Theory*

One line of theory, referred to here as 'efficiency theory', enunciates a productivity argument strongly favorable to limited liability. Its leading proponents, Easterbrook and Fischel, make this case by describing the situation of the publicly-held firm in a hypothetical regime of joint and several unlimited liability.¹⁴ They focus on the firm's equity investors and project problems they would encounter respecting monitoring, liquidity, and diversification under this unlimited liability regime. They identify four critical differences between limited and unlimited liability. First, with limited liability shareholders have a reduced need to monitor managers. Contrariwise, with unlimited liability, monitoring costs might be so high that much equity investment might not get made in the first place.¹⁵ Second, since a joint and several liability regime makes each shareholder potentially liable for the entire amount of an unsatisfied judgment, an unlimited liability regime would force shareholders to incur costs of monitoring one another's levels of wealth.¹⁶ Third, limited liability enables the transfer of securities on a trading market, ensuring liquidity. Absent limited liability, shares would be hard to value because they would carry the potential of visiting excess liabilities the probable magnitude of which would depend on the level of wealth of the holder and of the other holders in the group; as a result, stock pricing would encompass intractable variables¹⁷ and free transfer would be constrained.¹⁸ Fourth, by thus reducing the monitoring costs and downside risks of shareholding, limited liability facilitates diversification.¹⁹ Since diversification of holdings reduces the equityholders' risk, it lowers the firm's cost of capital. In addition, shareholder risk aversion is eliminated from the agency relationship so that management is freer to make riskier investments holding out greater returns. Thus is limited liability said to facilitate a more productive investment policy for the firm.²⁰

Easterbrook and Fischel acknowledge that moral hazard results when investors and managers are protected against potential liabilities for the firm's investment losses and costs suffered by third party tort claimants. But they do not deem

¹⁴ The leading article is Frank H. Easterbrook & Daniel R. Fischel, *Limited Liability and the Corporation*, 52 U. CHI. L. REV. 89 (1985).

¹⁵ *Id.* at 94-95.

¹⁶ *Id.* at 95-96.

¹⁷ Paul Halpern, *et al*, *An Economic Analysis of Limited Liability in Corporation Law*, 30 U. TORONTO L. J. 117 (1980).

¹⁸ Easterbrook & Fischel, *supra* note 14, at 95-96.

¹⁹ *Id.* at 97.

²⁰ *Id.* at 97.

that problem to be determinative. As to the firm's voluntary claimants, they argue that there is no externality since the voluntary creditors receive compensation in advance for the extra risk. As to involuntary claimants, they argue that the expected magnitude of unsatisfied tort liability will be minimal. The incentive to insure remains strong despite limited liability because tort liability still presents a threat to the underdiversified, firm specific human capital investments of the firm's managers. At the same time, they acknowledge that voluntary insurance will not provide a complete solution, pointing out that it is doubtful that firms can fully insure for all expected tort liability. But they nonetheless conclude that the benefits of limited liability outweigh the costs.

2. *Pro Rata Theory*

A contrasting approach, referred to here as 'pro rata' theory, has been articulated by Leebron and Hansman and Kraakman. This view follows from the assertion that most of the problems of unlimited liability identified by efficiency theory are solved if the regime of unlimited liability abandons the joint and several rule of partnership law in favor of a rule of pro rata liability based on and limited by the proportion of equity owned by each shareholder.²¹ The proponents assert that in a pro rata regime investors would not have to monitor one another's levels of wealth, and would have every incentive to diversify so as to reduce the proportionate size of their holdings. At the same time, the present system's perverse incentives to invest in suboptimally risky production functions would be eliminated. Negatives also are recognized — for example, the cost of equity capital would increase. But, according to Hansman and Kraakman, more productive outcomes still could be expected because managers and investors would emerge with high-powered incentives to limit the firms' pattern of risky activities or, failing that, to increase the level of investment in corporate insurance. A financial system benefit also is projected — business risk would be reflected in the share price.²² In sum, under the pro rata view unlimited liability does not adversely affect the role of shareholding in the financial system and even will serve to enhance firm performance.

²¹ David W. Leebron, *Limited Liability, Tort Victims, and Creditors*, 91 COLUM. L. REV. 1565 (1991).

²² More specifically, the emergence of a single share price would eliminate certain constraints on the movement of the share price. Hansmann and Kraakman explain that unlimited liability, as applied to the publicly traded corporation, would cause the stock price to 'incorporate available information about the full extent of ... possible losses'. Henry Hansman & Reinier Kraakman, *Toward Unlimited Shareholder Liability for Corporate Torts*, 100 YALE L. J. 1879, 1907 (1991).

The pro rata model has been criticized at the level of feasibility. It is said to suffer from two significant limitations. First, it is argued that contingent liability (unlimited or otherwise) would have little impact on share prices and liquidity. Given the fact that offshore investors are attachment proof and modern financial instruments permit investors to arbitrage the increased level of risk attached to the limited liability rule, little impact on the share price of firms can be projected.²³ The second limitation follows from a legal process perspective. Since a given forum may be blocked from obtaining jurisdiction over foreign shareholders, the enforcement of an unlimited liability system would carry significant administrative costs. As a result, it would be rational for creditors to pursue only the wealthiest foreign shareholders. That, in turn, would cause future investors to make decisions to purchase shares based on the wealth of the shareholders' pool.²⁴ On this analysis, the pro rata approach returns us in the to the scenario described under the efficiency view.

3. *Efficiency Theory, Pro Rata Theory, and the Limited Liability Company*

Ironically, LLC statutes proliferated across the states just as pro rata theory appeared to raise serious questions about the productivity effects of limited liability. Given pro rata theory, an across-the-board inefficiency presumption respecting limited liability became plausible for the first time. This has put proponents of LLC efficiency in an awkward position. Efficiency theory no longer supplies an unshakable basis for asserting that limited liability was a first-best result for public corporations. Indeed, even proponents of large firm limited liability now argue from the rearguard position of feasibility; their claim now in effect is that a limited liability regime is the first-best choice in a second-best world of practice due to technical problems and perverse incentives.²⁵ Furthermore, the feasibility objections to a pro rata regime at best rehabilitate limited liability only for publicly-traded firms and provide no basis for justifying limited liability for close corporations and LLCs.

LLC proponents have been forced to equivocate as a result. But, at least as to contract creditors, their efficiency claims retain a vigorous appearance. They make the familiar point that firms with limited liability have to pay more for

²³ Joseph A. Grundfest, *The Limited Feature of Unlimited Liability: A Capital Markets Perspective*, 102 YALE L. J. 387 (1992).

²⁴ Janet Cooper Alexander, *Unlimited Shareholder Liability Through a Procedural Lens*, 106 HARV. L. REV. 387 (1992).

²⁵ See Grundfest, *supra* note 23; Alexander, *supra* note 24. For an able rebuttal to both, see Mark. R. Patterson, *Is Unlimited Liability Really Unattainable?: Of Long Arms and Short Sales*, 56 OHIO ST. L.J. 815 (1995).

their credit, aligning the social costs and benefits of their activities.²⁶ They have more trouble with the irrelevance point — that is, that the shift of the risk of failure to the firm's voluntary creditors is matched by an offsetting increase in the cost of credit. They seek to refute it by repeating the basic points of efficiency theory, stretching them to fit the small firm context. The increased cost of credit, they say, is more than offset by (a) monitoring cost savings, for delegation to specialized managers occurs in the small firm context as well, and (b) diversification benefits, for sometimes venture capitalists collect portfolios of investments.²⁷ In addition, they say, all parties save the cost of negotiating into limited liability,²⁸ and small firm creditors are better positioned to diversify risk than are small firm equityholders.²⁹ As to involuntary creditors, in contrast, the proponents have to concede that the economics gives rise to a strong negative inference. They counter by pointing to the foregoing benefits respecting relations with voluntary creditors,³⁰ pointing to the possibility of veil-piercing,³¹ making old-fashioned appeals to the need to encourage capital formation,³² and repeating the point that the equity investments and risk aversion of small firm investors will lead to considerable internalization of tort risk.³³ At least one commentator boldly concludes that the benefits outweigh the costs.³⁴ The pro rata theory, meanwhile, is not confronted directly.

B. The Efficiency Theory of Limited Liability in a Larger Theoretical Context

This subpart situates the efficiency theory of limited liability within the larger framework of theories of agency and optimal capital and ownership structure. It does so in order to show that efficiency theory follows from a number of assertions prominent in the theory of the firm as postured ten or fifteen years

²⁶ Macey, *supra* note 13 at 449.

²⁷ *Ribstein II*, *supra* note 13, at 101-104. See also Macey, *supra* note 13, at 451.

²⁸ *Id.* at 105.

²⁹ Macey, *supra* note 13 at 450-51. One might ask whether in that case they should be expected to contract into limited liability anyway. For a strong argument that such would not be the case, see Richard A. Booth, *Limited Liability and the Efficient Allocation of Resources*, 89 Nw. U. L. REV. 140, 157-58 (1994).

³⁰ Macey, *supra* note 13, 449-50.

³¹ *Id.*; *Ribstein II*, *supra* note 13, at 129.

³² Macey, *supra* note 13, at 451.

³³ *Ribstein II*, *supra* note 13, at 127-28.

³⁴ *Id.* at 127-28. The other is more cautious, leaving the bottom line question open. Macey, *supra* note 13 at 449-50.

ago. Efficiency theory remains rooted in these assertions today. Meanwhile, the theory of the firm, like a caravan, has moved on.

More particularly, we focus on the implications of two assertions central to the efficiency case for the LLC: (a) that limited liability promotes efficiency by enabling diversified shareholding and liquidity, and (b) that diversified shareholding leads to an efficient firm investment policy. The question is whether these efficiency assertions are safe as a matter of economic theory. Our response focuses first on the assertions' close ties to first-generation agency theories of the firm and asks a question respecting those theories' success at evading the irrelevance point and, further to that point, describes a contrasting line of theory on management-investor incentive contracting. Our response next surveys some subsequent economic literature on financial contracting and optimal ownership structure that attempts to eliminate agency costs under a limited liability regime. Finally, we turn to a recent financial economic suggestion that, given the complexity of the agency problems of ownership structure and financial contracting, there may not a single ownership structure that deals with them optimally. An important contextual limitation should be noted: Involuntary creditors make no appearance in the economic theory of capital and ownership structure, and so we refer here only to models of relationships among managers, creditors, and equityholders.

1. The Irrelevance Hypothesis and First-Generation Agency Theory

Economic theories of capital and ownership structure have evolved as an extended response to the famous irrelevance hypothesis of Modigliani and Miller.³⁵ Under the Modigliani-Miller model, firm value in a full information and taxless world stems entirely from the production function and is independent of capital structure. Furthermore, the cost of capital is constant across all debt-equity ratios. Under the irrelevance hypothesis what goes for capital structure also goes for business form — the choice of corporate or partnership structure also makes no difference to the value of the firm, at least so far as concerns voluntary creditors. As noted above, the irrelevance point continues show up in legal discussions of limited liability when it is noted that the interest rate fully reflects risk shifted in the creditors' direction.³⁶

Agency theory rebuts the irrelevance hypothesis by showing that frictions that

³⁵ Franco Modigliani and Merton H. Miller, *The Cost of Capital, Corporation Finance and the Theory of Investment*, 48 AM. ECON. REV. 261 (1958).

³⁶ Easterbrook & Fischel, *supra* note 14, at 96.

impact on the value of the firm's production function emerge from features of standard debt and equity contracts. It holds that, as a result, an optimal capital and ownership structure for the firm obtains as a theoretical proposition. The efficiency theory of limited liability employs this agency perspective³⁷ when it asserts that the single limited liability ownership structure reflects the optimal arrangement for productive investment.

Recall Jensen and Meckling's classic model of frictions attending standard debt and equity contracts.³⁸ Here we see limited liability make a first appearance in a model of optimal capital and ownership structure. The model asserts that agency costs attach to both equity and debt. As to debt, conflicting interests of debtholders and equityholders give equityholders an incentive to invest suboptimally. Given the debt contract's provision for a fixed payment, equityholders receive a fairly large portion of the positive returns on investment. Yet, given limited liability, debtholders can experience a greater impact on the downside if the investment fails. The limited liability regime thus is not irrelevant and indeed is suboptimal because its differential effect on downside risk gives the equityholders an incentive to invest in highly (and suboptimally) risky projects. As to equity, costly conflicts arise between managers and outside equityholders because the managers are not the residual owners of the firm. The managers do not gain pro rata from its profitmaking activities. Since they are unable to diversify their risky human capital investments and at same time remain exposed to the firm's downside risk, they will tend to pursue their own interests at the expense of wealth-maximizing activities for the firm.

Jensen and Meckling looked to contractually grounded monitoring and incentive schemes to offset these agency costs of capital and ownership structure. By hypothesis, an optimal capital and ownership structure is the one that minimizes these agency costs. The debtholders, for example, will anticipate the asset substitution problem described above and will attempt to minimize its effect (and the effects of other agency costs of debt) with covenants and by increasing the cost of the debt. Furthermore, certain firms could commit themselves to operate in the interests of their equityholders and restrict managerial shirking by increasing the amount of debt.³⁹ In this and related models,

³⁷ The fundamental articles are Michael Jensen and William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Capital Structure*, 3 J. FIN. ECON. 305 (1976); Eugene Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288 (1980); and Eugene Fama and Michael Jensen, *Agency Problems and Residual Claims*, 26 J. L. & ECON. 327 (1983).

³⁸ Jensen & Meckling, *supra* note 37.

³⁹ The attempt to resolve the conflict between managers and shareholders by taking on

then, the central concern is to show how the capital structure can be employed as an incentive instrument. The efficiency theory of limited liability follows precisely this pattern when it asserts that limited liability is needed to facilitate shareholder diversification because diversification permits managers to achieve the productivity benefits of a risk neutral investment policy.

But a series of objections have been raised against this agency view of the firm. Strictly speaking, when agency theory holds that capital structure manipulation is the dominant strategy for influence management productivity, it assumes that the terms of the managers' contract with the equityholders are fixed. It thereby omits to consider the alternative option of offering the managers incentives not to interfere with the firm's choice of financing.⁴⁰ If we can materially influence the managers' incentives by varying the terms their contract, it is reasonable to assume that the same incentives can be offered under different capital structures. In theory, then, unless agency theory can explain why changes in capital structure cannot be undone by corresponding changes in the contractual incentive scheme, agency analysis reemerges as consistent with Modigliani and Miller hypothesis and we lapse back to irrelevance. The same result would follow for limited liability.

more debt can of course result in new conflicts between debtholders and equityholders, as many learned to their regret during the 1980s and early 1990s.

In a related model, developed in Diamond, *Financial Intermediaries and Delegated Monitoring*, 51 REV. ECON. STUDIES 393 (1984), the agency problem between manager and outside investor is analyzed in terms of introducing an optimal penalty which operates to maximize the manager's expected payoff. Viewing the basic framework in terms of whether verification costs can be minimized, Diamond's model implies that in the case where a manager can appropriate any income not paid out, a non-pecuniary penalty can be imposed on the agent as a basis of what is paid out. The optimal penalty is a standard debt contract which permits the investor to appropriate all the reserve. The problem with Diamond's model is that it is not consistent with ownership of equity claims made by outside investors. That is, these debt-like contracts, which assume risk-neutrality, one period contracting, a single investor and deterministic verification, are too simplistic and, as a result, fail to inform about contract situations between investors and managers.

⁴⁰ See Bengt Holmstrom and Jean Tirole, *The Theory of the Firm*, in R. Schmalensee and R. Willig, (eds) 1 HANDBOOK OF INDUSTRIAL ORGANIZATION 81 (Amsterdam: Elsevier, 1989).

2. *Limited Liability for Managers and Models of Investor-Manager Incentive Contracts*

Contracting between managers and equity investors having been asserted as means of reasserting the theoretical irrelevance of capital and ownership structure, we here pause to examine a few of these models. Unsurprisingly, the managers' posture as to limited or unlimited liability for business failure turns out to be a central variable. Also unsurprisingly, the question whether capital structure is in fact a critical component in an optimal incentive structure remains sharply contested. But today that contest proceeds in an assumptional context quite different from that prevailing in the first-generation agency models that inform the efficiency theory of limited liability.

The earliest manager-investor models followed an agency framework and asserted that risk-sharing between manager and investor could lead to an optimal outcome, given a situation of asymmetric information at the time of contracting and risk neutrality on the part of the manager. In addition, these simple models assumed that the output of the firm, although influenced by the activities of the manager's effort, is nevertheless observable. For the most part, these models' moral hazard approaches were based on the insight that the manager, before contracting, can select a distribution over the output of the firm which is influenced by his effort.⁴¹ Under these models, it was thought optimal for the manager to rent the technology from the investor.

Harris and Raviv, employing these assumptions, moved this literature forward a step to show that a self-interested principal can design an optimal contract with a firm's manager.⁴² This model asserts that in the absence of limited liability or other risk constraints, the optimal contract mitigates the agency problem by placing all the risk and upside returns for the project on the manager. The investor, in contrast, receives under the contract a fixed amount in exchange for his investment. Giving the manager all the returns from the project is asserted to mitigate the agency problem. This is achieved, however, only because the model assumes that there exist contractual institutions, for example, the posting of a bond, which guarantee that the agent does not breach the contract regardless how costly that course of action is for the agent. In effect, the manager's position in this model corresponds to that of a holder of unlimited liability equity, with the position of the investor corresponding to

⁴¹ See Holmstrom and Tirole, *supra* note 40, at 80.

⁴² Milton Harris & Arthur Raviv, *Optimal Incentive Contracts With Imperfect Information*, 20 J. ECON. THEORY 231-59 (1979).

that of a holder of riskless debt. Meanwhile, the fixed payment to the investor limits the model's feasibility⁴³ — we are not yet really modelling equity investment.

Subsequent models are more robust. For one thing, they achieve limited liability for the manager. In a model developed by Innes,⁴⁴ the costly effort of the manager (which the investor cannot observe) improves the expected returns of the investor. Here the investor's compensation is constrained to be nondecreasing in firm profit.⁴⁵ Under the model, if the investor's compensation is monotonic-increasing, the investor's first best choice will be a debt contract. But without the monotonic constraint, the optimal contract will give the manager all the profits in some high profit states and none of the profits when the firm's losses are below a given level. But this more realistic model still suffers from the monotonicity requirement. This constraint, Innes notes, 'can be motivated either by a requirement that investors never have an incentive to sabotage the firm or by an ability of entrepreneurs to costlessly revise their profit reports upward (with hidden borrowing for example)'.⁴⁶ Neither of these situations is likely enough so as to provide support for Innes' debt-contracting result.

Other recent models get a step closer to replicating the observed relationships of managers and investors with ownership claims. Williams offers a multi-period model of the firm which involves a risk-averse manager and investors who are in effect risk-neutral.⁴⁷ Here the assumption is that the manager's effort influences firm output which is unobservable by outside investors. The investors commit at $t = 0$ in reliance on an *ex ante* monitoring system that functions to restrict the manager from appropriating the firm's returns, specifically, the provision of collateral for debt. The model provides that the value of the collateral is uncertain at $t = 1$ and observed only by the manager. The model stipulates that financial contracts must specify which fraction of the collateral and what amount of cash should be transferred to the outside investor. To be sure, this depends on the manager's report, which depends on the unobserved value of the debt. When the manager reports the earnings of

⁴³ See Robert Innes, *Limited Liability and Incentive Contracting with Ex Ante Action Choices*, 52 J. ECON. THEORY 45 (1990).

⁴⁴ *Id.*

⁴⁵ This is consistent with the view that all financial contracts are nondecreasing, for example, the optimal debt contract.

⁴⁶ *Id.* at 46.

⁴⁷ Williams, *Ex Ante Monitoring, Ex-Post Asymmetry and Optimal Securities* (UBC Working Paper 1989).

the firm, the manager distributes the earnings as set forth in the contract. While the optimal contract would have the manager allocating the entire collateral to investors, this would lead to a control loss to the manager. Thus, the optimal contract is incentive compatible — outside investors receive the entire asset and no cash when the value of the asset and control value are low; and, correspondingly, when the values are high, they receive a fraction of the value. Interpreting the results of this model, the assertion is that optimal contracts involve features of equity and debt.

The dynamic and result of this model contrast starkly with those of the earlier agency cost exercises respecting manager-investor relations. Since those models assume that the manager can affect the distribution of returns, they have to rely heavily on techniques like monitoring and verification devices and deadweight penalties in order to get optimal results. Here, in contrast, a contractual priority does the job. Note also that the Williams model, with its emphasis on the problematics of verifying firm results over time, highlights the excess simplicity of the agency model of Jensen and Meckling, which focused on a financial contract over a single period only. In order to achieve the result that changes in the capital structure can be used as an incentive device to align the interests of managers, that and similar first-generation agency models had to assume that firm profitability and cash flows are fully contractible. The Williams model, like other recent work in financial economics, alters these basic assumptions considerably. Here, more in line with the experience of actual firms, contracting for optimal investment incentives must cover contingencies that unfold over time. In addition, these models look past the debt equity-ratio to changes in the institutional features of the firm for effective means to limit the ability of manager to appropriate the firm's returns.

But, significantly, the contractual priority in the Williams model gets its incentive power from its debt-like characteristic. Therein lies its contestibility. A contrasting line of multi-period asymmetric information models asks sharp questions about the relative effectiveness of management-investor contracts and control transfer structures bound up in capital structure as means to channel management incentives in productive directions. The economists responsible for these models assert that to the extent that crucial management choices are noncontractible due to problems of observability and verifiability, monetary incentive schemes based on firm profitability (or stock market performance) cannot be expected to import adequate discipline. Control structures allowing outsiders to take actions that managers dislike in the event of poor firm performance, although a second-best solution, can be expected to do a more

effective job of manipulating management incentives in productive directions.⁴⁸

Hart offers a more formal expression of this point. He notes that given managers who derive no private benefits from control of assets, first-best results easily can be achieved (in a taxless world) with an all equity capital structure and a simple incentive compensation system. In a two-period situation he would simply make the managers' compensation depend entirely on the dividend. That is, assuming investment at $t = 0$, and cash flows to be realized at $t = 1$ and $t = 2$, incentive compensation I should be $p(dt=1 + dt=2)$, where p is a small positive number. If the payment also covers liquidation proceeds L at $t = 2$, then $I = p[dt=1 + (dt=2, L)]$, and the manager can be expected to make an optimal decision respecting liquidation at $t = 1$. If at $t = 1$, the expected L is greater than the cash flow expected at $t = 2$, the firm is liquidated at $t = 1$ and no indebtedness is needed in order to align management incentives.⁴⁹

But managers do derive private benefits from asset management, and in Hart's conception, the bribe p required align their incentives with those of the outside security holders is unfeasibly large. Accordingly, a complex capital structure that includes control mandates must be interpolated. And, in a dynamic environment, a range of possibly optimal contractual formulas for setting the terms of that control transfer can be suggested; uncertainty makes it impossible to deem any one *ex ante* optimal.⁵⁰ Restating this point, it now is the under-

⁴⁸ Mathias Dewatripont and Jean Tirole, *A Theory of Debt and Equity: Diversity of Shareholders and Manager-Shareholder Congruence*, 109 Q. J. ECON. 1027, 1028 (1994).

Similar observations have been made respecting the agency dynamics of investment within a firm. Arjit Mukherji and Nandu Nagarjan, *Moral Hazard and Contractibility in Investment Decisions*, 26 J. ECON. BEHAV. & ORG. 413 (1995), models the situation of a principal investing in research and development projects. They show that if the principal receives verifiable 'hard' signals concerning the quality of the projects during the development period, the principal will be able to make a full *ex ante* commitment to a project but that problems of opportunism and monitoring costs still will make for a second best result — the principal rationally will overinvest relative to the first best. In contrast, in a world holding out only 'soft' noncontractible information prior to the last period, underinvestment is predicted.

⁴⁹ OLIVER HART, FIRMS, CONTRACTS, AND FINANCIAL STRUCTURE 198 (1995). Note an interesting real world implication of these observations — incentive compensation should not come in the form of stock options but in the form of illiquid long positions in the stock.

⁵⁰ See William W. Bratton, *Dividends, Noncontractibility, and Corporate Law*, __ CARDOZO L. REV. __, __ (forthcoming 1997).

standing that a simple one-period incentive contract that sets the firm's capital structure based upon a particular projection of the appropriate direction for the agents' activities will not be optimal for all future scenarios. A significant question arises for the efficiency theory of limited liability as a result — whether it follows that, in a dynamic and uncertain environment, more than one liability structure for the firm's owners might have to be suggested as possibly optimal, rather than the single structure, as assumed in first-generation agency theory.

3. *Optimal Ownership Structures, Agency Theory, and Limited Liability*

The efficiency theory of limited liability relies heavily on a second line of first-generation agency theory when it suggests that a single ownership structure maximizes the value of the firm. More particularly, its operative notions are (a) that diversified, that is, dispersed shareholding leads to efficient investment policies, (b) that limited liability, by promoting diversification, provides high-powered incentives for firm managers to invest the firms' resources in assets whose value is higher than under the next available alternative, and (c) that limited liability creates value by assuring easy transferability of shares, presumably due to an assumption that optimal incentives obtain inside the firm when its equity interests are traded in an outside market with maximal liquidity.

The line of agency theory that supports these notions looks to the structure of ownership to ameliorate moral hazard problems on the part of those performing the production function. This connection between ownership structure and production can be traced back to the classic analysis of Alchian and Demsetz.⁵¹ Their model looks into the incentive problems of team production and asks how the owners of the asset can induce the manager of the asset to cooperate. The model introduces two mechanisms to overcome the control problem — monetary incentives and a third party monitor — and assumes that the monitor can measure the agents' performance. Fama and Jensen later sharpened this story by centering on how the structure of ownership can be altered to limit the externalities tied up with the incentive problems of joint production. More specifically, they argued that an ownership structure, such as a partnership, can be designed so as to produce an optimal outcome for the firm. The equilibrium result is asserted to follow from the role played by contractual constraints enforced by third parties.

⁵¹ Armin Alchian and Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777 (1972).

This inquiry into the relationship between ownership structure, team production, and firm value took a long step toward robustness when Holmstrom identified concentration of equity ownership as a critical bottom line factor.⁵² Holmstrom's model is concerned with techniques for disciplining production team members. Holmstrom emphasizes that, given technological non-separabilities and problems in monitoring individual contributions to firm output, there is no sharing rule which can achieve an equilibrium outcome. This is because the team members will always have an incentive to collude so as to facilitate shirking and therefore cannot enforce a sharing agreement among themselves. Hence, there must always exist a principal to enforce penalties respecting shirking. More particularly, the moral hazard problem respecting the agents calls for an incentive scheme which 'breaks the firm's budget constraint'. In other words, given bad news about team performance a budgeting authority must be in a position to cut off needed capital.⁵³ Holmstrom suggests that shareholders with an ongoing contingent commitment to provide capital could perform this incentive function; with the occurrence of the contingency related to team performance they are released from their funding commitment. Furthermore, in this model, the incentives are provided by a marginal source — investors. In the face of contingencies they will have cooperate in order to finance the marginal distribution of profits. As a result, to the extent that investors are called on to make contributions to a fund it is unlikely that free-rider problems will arise.

A final problem remains for solution in the Holmstrom model. With it we reach the model's impact point for the present discussion. To the extent that equity ownership requires monitoring, says Holmstrom, there will be an incentive for some owners to free ride on other owners' efforts. From a monitoring perspective, then, it might be optimal to have a single owner. Thus do the costs of independently monitoring the firm and pledging capital for financing give rise to a question respecting the optimal level of concentration of ownership.

The problem that Holmstrom identifies — the relationship between ownership concentration, liquidity, management agency costs, and investor incentives respecting governance — is, of course, well-known to corporate lawyers as the separation of ownership and control. Holmstrom's suggestion that concentration might help solve the problem was novel. After all, when he wrote in

⁵² Bengt Holmstrom, *Moral Hazard in Teams*, 13 BELL J. ECON. 324 (1982).

⁵³ At the margin, says Holmstrom, this is more likely to produce an equilibrium outcome. *Id.* at 327.

the early 1980s, takeovers and other market controls were thought to be adequate to the task of overcoming shareholder collective action problems. This line of agency theory, then, anticipated the turn taken by the 1990s corporate law discussion of governance initiatives for institutional shareholders.⁵⁴ It has disturbing implications for efficiency theory — because it asserts without equivocation that limited liability enhances productivity by discouraging concentration and encouraging diversification.⁵⁵

This theoretical inquiry into optimal ownership structure remains at an early stage of development, however. As it evolves it centers on the problems facing increased levels of firm ownership in the presence of private information. As is well known, if shares are highly diversified there are few high-powered incentives for a single investor to invest in monitoring and control. Blockholding is the obvious place to turn to solve the problem of low-powered shareholder incentives to invest in monitoring and control that come with high diversification. But blockholding itself is discouraged by the fact that the blockholder incurs the significant cost of foregoing her chance to diversify her portfolio to the maximum. Shleifer and Vishny⁵⁶ took a swipe at this problem with a model of an equity financed firm in which there is one large shareholder and a number of small shareholders who free-ride. In this model, firm value increases with a larger shareholder's presence. Consequently, in the model, the large shareholders are likely to have an incentive to retain their large shareholdings. The problem comes if the large shareholders ever get into a position to sell their shares anonymously in the trading market — they will have every incentive so to do. A recent model from Bolton and von Thadden⁵⁷ takes a second look at this problem. They examine the properties of a choice between concentrated, illiquid shareholding and a combination of a control block and a publicly-traded, noncontrolling portion of the firm's stock. The question is whether a closely held firm can go public with a big block still in place under an arrangement where the small holders compensate

⁵⁴ See, e.g., MARK J. ROE, *STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE* 3-49 (1994).

⁵⁵ We note that pro rata theory asserts that pro rata unlimited liability encourages diversification. But there is an important point of distinction from efficiency theory. With pro rata theory diversification proceeds along with enhanced monitoring incentives. Efficiency theory, in contrast, claims that decreased monitoring incentives are efficient.

⁵⁶ Shleifer and Vishny, *Large Shareholders and Corporate Control*, 94 J. POL. ECON. 461 (1986).

⁵⁷ Patrick Bolton and Ernst-Ludwig von Thadden, *Blocks, Liquidity and Corporate Control* (paper presented at Journal of Finance Intermediation Symposium, Loosdrecht, Holland, June 1996).

the remaining blockholder for the cost of foregone diversification. In theory, such a deal holds out advantages to the small holders since the monitoring services of the control block will likely lead to greater returns than would be received with fully dispersed shares. But the arrangement runs right into the a problem identified by Shleifer and Vishny in the precedent model.⁵⁸ Since the trading market will be anonymous, the large shareholder will have an incentive to take in the compensation through one door and unwind his position through slow market sales out the other door. The result is that there will be few incentives on the part of the small holders to commit to paying for the monitoring ex ante. This in turn means that blockholding will be less attractive. In addition, if it is the case that public trading aggravates information asymmetries between the blockholder and the small holders, there will be an additional negative impact on the feasibility of a financial arrangement between the blockholder and the rest of the shareholder group. The small holders will be willing to enter into the arrangement only in a very special case: They will have to have reliable information about the future plans of the blockholder. Unsurprisingly, Bolton and von Thadden conclude that there is no optimal tradeoff between liquidity and concentration.

Thus does this line of inquiry prompt questions about efficiency theory's association of diversification and productivity. Significantly, it in addition has prompted a model that reconsiders of the whole place of limited liability in the theory of the firm.⁵⁹ This model, put forward by Winton, suggests, first, that contingent shareholder liability is feasible and holds potential productivity benefits, and, second, that shareholder assumption of additional liability is interconnected with the efficient choice of an ownership structure. Winton notes that his model is motivated by the successful appearance in a number of cases in practice of unlimited liability with respect to large firms. He cites a range of cases, including Lloyds of London, unlimited liability for shareholders in Britain, and double liability for chartered banks in the United States.⁶⁰

In the model, Winton stipulates that there are a number of large (symmetric) shareholders who each may be responsible for additional financing for the firm. The model also assumes that any investor can monitor the activities of

⁵⁸ Shleifer and Vishny, *Large Shareholders and Corporate Control*, 94 J. POL. ECON. 461 (1986).

⁵⁹ Andrew Winton, *Limitation of Liability and the Ownership Structure of the Firm*, 48 J. FIN. 487-512 (1992).

⁶⁰ *Id.* at 489. For a fuller presentation of the history see PHILLIP I. BLUMBERG, *THE LAW OF CORPORATE GROUPS: TORT, CONTRACT, AND OTHER COMMON LAW PROBLEMS IN THE SUBSTANTIVE LAW OF PARENT AND SUBSIDIARY CORPORATIONS*, §§ (1987).

management and that the investors will always prefer to increase the amount of wealth they invest in the firm. The model begins by showing that the wealth effects of increasing shareholder concentration depend on the cost function of monitoring — if the cost of monitoring is positive, an increase in the number of shareholders causes the value of the firm to decrease. The model shows that, given the adverse selection problem that thus arises when there is additional liquidity, the investors have an incentive to commit their external wealth to bond management. The model assumes that most of the investors' external wealth is illiquid. Given this, the model asserts that they will prefer to commit their assets through a contingent guarantee, that is, collateralized debt, rather than to make an actual investment in the firm. This is asserted to reduce the probability of liquidation costs. The model's insight is that so long as the firm is funded by a large number of shareholders via collateralized debt, wealth illiquidity will impose a transaction cost that mitigates the adverse selection problem on both sides of the market, causing the average price of a share to reflect the residual wealth of the poorest outside shareholder. Thus does the model challenge the position that unlimited liability causes the value of shares to decrease because it causes the shares to gravitate to the hands of poorer investors who have less to lose.

Some additional assumptions made by the model must be noted, however. Specifically, Winton cannot get his result favoring a contingent liability regime without trading restrictions on the equity and wealth verifications respecting the shareholders.⁶¹ At the bottom line, then, this model of contingent liability asserts that, although increasing shareholder liability has benefits as well as costs, there is a difficult cost-benefit tradeoff choice between adverse selection and costly restraints on trading. Unsurprisingly, this tradeoff between liquidity and monitoring requires empirical investigation.

All of the foregoing having been said, we note an absence of conclusive empirical work on the connection between ownership structure and firm performance.⁶² The studies closest to point send conflicting signals. An early study Demsetz and Lehn⁶³ found no significant relationship between ownership concentration and accounting profit rate.⁶⁴ But, in a different context,

⁶¹ Winton notes that limiting sale of shares without approval or requiring residual liability has been employed in many unlimited liability settings. Winton, *supra* note 59, at 500.

⁶² To our knowledge.

⁶³ Demsetz and Lehn, *The Structure of Corporate Ownership: Causes and Consequences*, in 1 DEMSETZ, OWNERSHIP CONTROL AND THE FIRM, THE ORGANIZATION OF ECONOMIC ACTIVITY 202-222.

⁶⁴ Thereby supporting Demsetz's earlier insights. *Id.* at 217-19.

Wruck observes that private placements of equity produce higher shareholder concentration and positive stock prices,⁶⁵ and concludes that the public, perceiving that higher shareholding concentration involves better monitoring, places a higher value on the firm. Cutting the other way is a study by Leach and Leahy⁶⁶ which reveals that in firms where the non-diversifiable risk is high, there is likely to be more shirking. In this regard, the benefits to shareholders from monitoring is higher. But this study also finds no evidence that higher shareholder concentration produces a higher return on investment.

C. Some Questions About Insurance

Corporate law teachers like to rely on insurance as the solution to the problem of limited liability. Both the efficiency and pro rata theories do likewise at critical junctures, but with radically different treatments. Serious questions can be asked about both.

1. *Efficiency Theory*

Easterbrook and Fischel suggest that limited liability does not give rise to significant externalities because corporations will contract for insurance in respect of activities which implicate significant social costs. Given limited liability, of course, corporations have an incentive to invest in risky activities even when they cannot pass the extra costs along to consumers. One result is that the firm, in order to capture the market rents it requires, will transfer some of the costs to involuntary creditors. How then, given that the shareholders have limited liability and incentives to diversify, could it be cost effective for the firm to contract for insurance? Intuitively, when the firm contracts for risk coverage of its socially costly business activities it pays extra for protection its shareholders already have. Accordingly, the incentive to insure must stem instead from limited possibilities to diversify the negative spillovers of business risk on the part of managers, employees, and certain investors. An additional cost incentive stems from risk sensitivity on the part of voluntary creditors who adjust contract terms to reflect risk — that is, lower interest rates on debt offset the cost of insurance to some extent. Once a limited liability entity thus purchases tort liability insurance, say Easterbrook and Fischel, it will have less of an incentive to transfer risk, and a diminished

⁶⁵ Wruck, *Equity Ownership Concentration and Firm Value: Evidence from Private Equity Financings*, 23 J. FIN. ECON. 1 (1989).

⁶⁶ Leach & Leahy, *Ownership, Control Classifications and the Performance of Large British Companies*, 101 ECON. J. 409 (1991).

incentive to invest in risky activities. In addition, to the extent that the firm insures, there will be less probability of organizational collapse via bankruptcy. At the bottom line, however, Easterbrook and Fischel caution that they do not claim that the insurance incentive they describe completely eliminates the incentive to engage in risky activities that follows from limited liability. Ribstein extends this analysis to the LLC, arguing that LLC members will have sufficient incentives to insure for their potential tort liability.

Hansmann and Kraakman object to the Easterbrook and Fischel analysis. In their view, firms with limited liability will have an incentive to underprovide for insurance. Why should managers invest in insurance, they ask, when it may indicate to outside investors that they are shirking? Managers may want to show investors that they are undertaking sufficiently risky investments without drawing attention to their preference for their career concerns. In addition, liability insurance contracts have ceilings on the upper limits of coverage,⁶⁷ leading to decisions to insure at a low coverage limit. Firms also may either mistake the frequency of claims or anticipate that a claimant will settle rather than pursue the full claim. The fact that firms frequently pursue an underinsurance strategy suggests that shareholders will have low-powered incentives to protect potential tort victims. And even if a firm wanted to purchase full insurance coverage, the existence of moral hazard and loading costs, say Hansman and Kraakman, destroys any incentive to follow through. Hillman, in turn, has countered Ribstein's extension of the Easterbrook and Fischel analysis to the LLC. He observes that Ribstein fails to take into account the differences between insurance incentives respecting public corporation ownership structures and small firm ownership structures.⁶⁸ He notes, for example, that the incentive will not obtain when the firm's assets are worth less than its potential liabilities. In the alternative, he suggests that risk averse employees and managers of underinsured or undercapitalized firms could instead bargain ex ante for additional compensation as a substitute for insurance. We find these criticisms persuasive.

2. *Pro Rata Theory*

Insurance also figures importantly in the case for pro rata unlimited liability. It is an essential support of the theory's predictions of a high-powered share-

⁶⁷ Hansmann & Kraakman, *supra* note 22, at 1889. See also Gur Huberman, David Mayers & Gifford Smith, *Optimal Insurance Policy Indemnity Schedules*, 14 BELL J. ECON. 415 (1982).

⁶⁸ Hillman, *Limited Liability and Externalization of Risk: A Comment on the Death of Partnership*, 70 WASH. U. L. Q. 477, 480-1 (1992).

holder monitoring incentive respecting suboptimal risky investment and of only modest increases in the cost of liability to investors. The two predictions can be made simultaneously only to the extent liability insurance actually would be available to firms under an unlimited liability regime. If the insurance is unavailable, unlimited liability will indeed mean stepped up costs to investors. Given complete insurance, those costs could be contained with shareholders still having a high-powered incentive to reduce risk-taking due a desire to keep down the insurance's cost. Hansmann and Kraakman admit, however, that insurance markets are essentially incomplete,⁶⁹ with their performance also being hobbled by moral hazard, asymmetric information, and loading costs. The viability of their theory accordingly depends on the robustness of their back up assertion that the insurance market nevertheless substantially performs its job. They argue that loading costs, while substantial, are unlikely to be significantly greater than the costs, for example, of defending tort actions or the transaction costs related to bankruptcy. They argue in addition that insurance firms are generally able to control moral hazard through ratings and monitoring of potential insureds. It follows, they say, that it can be assumed that there would be no higher level of risk-bearing by investors under unlimited liability.

We wonder whether pro rata theory here asks for more than the insurance market can bear. The assertion that the insurance market works well enough is based in the first instance on the assumption that insurers, through experience, ratings, and menus, are able to design contracts which effectively reduce adverse selection and moral hazard. Early work in the economics of insurance supports this conclusion, showing the existence of an equilibrium in which high risk and low risk types separate themselves out by selecting different price-quantity policies.⁷⁰ More recent work provides additional confirmation, showing that in contracts where a menu is available to policyholders to select the amount of coverage based on price per unit, policy-holders tend to sort themselves out based on their type.⁷¹ But there is also some evidence to the contrary. It has been suggested that experience-rated contracts can lead to first-best outcomes only under limited conditions.⁷² Indeed, these contracts are

⁶⁹ They neglect to point out that in some cases insurance may not be available. Joseph Stiglitz, *SOCIALISM*, 287-8 (citing to working paper).

⁷⁰ Rothschild & Stiglitz, *Equilibrium in Competitive Insurance Markets: An Essay on the Economics of Imperfect Information*, 90 Q.J. ECON. 629 (1976).

⁷¹ In practice, the insurance industry tends to rely on multi-period experience-related contracts to select out high and low risk types.

⁷² Stephen D'Arcy & Neil Doherty, *Adverse Selection, Private Information, and Lowballing in Insurance Markets*, 63 J.BUS. 145, 148 (1990), citing S. Gal & M. Landsberger,

thought feasible where an insurer has comparative advantage over rivals in monitoring the claims histories of policyholders.⁷³ Hence, if there, exists, for example, an information asymmetry regarding valuable claim information, the underwriting policies with respect to new policies could lead to a lowballing price policy. And, the evidence of lowballing is consistent with the presence of adverse selection in selected insurance markets, such as that for automobile policies.

We also have questions about the assertion that the insurance market can handle increased levels of risk and demand that would follow a shift to an unlimited liability regime. The insurance industry, like other industries, may be subject to underinvestment problems which lead to the reduction of the value of its firm's equity and policies. To be sure the degree and location of the problem will depend on the situation. The ability of insurers to insulate themselves from exogenous shocks (due to interest rates and so forth) may be related to their ownership structure, capital market access, and reinsurance availability and ownership structure varies across the insurance industry.⁷⁴

The literature on insurance, considering this industry capacity question from another angle, asserts that firms operating in insurance markets have a basic shortcoming — there is a limit on the amount of insurance that any one of them can offer.⁷⁵ Moreover, capacity in insurance markets fluctuates. Under this constrained capacity view, unanticipated claims on insurance firms lead to a loss in equity that can be replaced either internally or externally. Given sudden and excessive losses, the insurance firms' short term supply curve will shift. To the extent that they perfer internal capital, they will have to respond by increasing premiums. As a result, capacity will be constrained. This constrained capacity model is thought fairly to explain the reasons for cyclical changes in premiums for insurance contracts.⁷⁶ Given the existence of an underwriting cycle, some have been led to suggest that there exists an imbal-

On 'Small Sample' Properties of Experience Rating Insurance Contracts, 103 Q. J. ECON. 233 (1988).

⁷³ *Id.*, citing H. Kunreuther & M. Pauly, *Market Equilibrium with Private Knowledge: An Example*, 26 J. PUB. ECON. 269 (1985).

⁷⁴ See Neil Doherty & James Garven, *Insurance Cycles: Interest Rates and the Capacity Constraint*, 68 J. BUS. 383-404 (1995).

⁷⁵ R.A. Winter, *The Liability Insurance Markets*, 5 J. ECON. PERSP. 115, 126 (1991).

⁷⁶ Of course much of the industry losses suffered during the 1980s could be linked to adverse selection and other characteristics of the insurance market. In the 1990s, in contrast, the insurance and re-insurance industry in the 1990s faces a new capacity constraint which is linked to more frequent and more costly natural disasters taking place.

ance between supply and demand in the industry.⁷⁷ Insurance company earnings lately have been substantially impacted by losses and the capital bases of insurance companies are under review. As a response to this new capacity constraint, the Chicago Board of Trade in 1995 introduced a new catastrophe option to hedge against risk of loss due to unexpected events.⁷⁸ Although the introduction of an option contract provides an important new asset to control risk, it should be noted that this instrument offers only a small reduction in an insurer's exposure to credit risk.⁷⁹

This goes only to say that more empirical support may be needed to sustain Hansmann and Kraakman's assertion that contracting institutions within the insurance industry work reasonably well. It is an open question whether the insurance market is sufficiently stable and predictable to provide the liability insurance under an unlimited liability regime. It also should be noted the complexity of this industry's problems may make the requisite support difficult to marshal. The possibility of controlling moral hazard and other market imperfections is difficult to measure unless the individual performance of each firm in the industry is evaluated. What, for example, are the incentives to monitor and supervise managers in an industry which may suffer financial losses for idiosyncratic reasons rather than because of moral hazard?

II. REGULATORY COMPETITION AND THE LIMITED LIABILITY COMPANY: LAW AS DOMESTIC PRODUCT

Proponents of the LLC employ a regulatory competition story to counter negative implications arising from the back-and-forth debate on limited liability. This line of defense draws heavily on the literature that describes and justifies state competition for public corporation charters. That precedent regulatory competition story is retold in the first subpart below. The subparts that follow confront and refute the story's extension to the LLC. This three-part analysis first considers the prospects for adoption of an LLC statute in a hypothetical island jurisdiction assumed to have an income tax system and interest group alignment identical to those of a typical American state. This discussion invokes public choice theory to project that special interests in the

⁷⁷ Michael Canter, Joseph Cole & Richard Sandor, *Insurance Derivatives: A New Asset Class for Capital Markets and a New Hedging Tool for the Insurance Industry*, 4 J. DERIVATIVES 89 (1996).

⁷⁸ The contracts were introduced based on information that insurance losses could potentially limit the overall effectiveness of the industry. *Id.* at 92.

⁷⁹ *Id.* at 95.

jurisdiction will procure an LLC statute. The second part extends this analysis to a hypothetical federal system of four states in which charter competition is precluded by a *siège réel* choice of law rule. Here the question is whether the enactment of an LLC statute by a single state in the federation can lead to a race-to-the-bottom. The discussion shows that possibilities for externalizing the costs of torts make a race-to-the-bottom a structural possibility. But it also projects that this race-to-the-bottom scenario is highly unlikely to occur in practice. The third and final part carries the analysis to a hypothetical federal system in which charter competition is a structural possibility. Here the question is whether the enactment of LLC statutes can be characterized as a competitive race-to-the-top. The discussion acknowledges the possible presence of competitive influences. But it concludes that these do not provide a plausible basis for explaining either the initial proliferation or ongoing evolution of LLC statutes. Domestic rent-seeking by interest groups, the explanation offered for the first part's island jurisdiction, provides a better explanation even in the context of a federal system. Interstate competition emerges in a secondary posture, taking its usual role as an inevitable limiting factor on state-level economic regulation. Thus positioned, it cannot support an efficiency presumption, and, accordingly, has no significant justificatory role to play for the LLC.

A. Corporate Charter Competition

Regulatory competition is an economic theory of governmental organization that equates decentralization with first-best equilibrium results. The theory analogizes law to product and then asserts that junior level governments — local, state, or national, as opposed to federal or super-national — compete for citizens and factors of production when they regulate.⁸⁰ It predicts that such competitively-determined regulation will satisfy citizen preferences. The prediction has a normative implication for legal and political theory: Just as price competition disciplines producers of private goods for the benefit of consumers, so regulatory competition promises to discipline government producers for the benefit of taxpaying citizens. Two distinct benefits are said to follow — the distortions that result as interest groups compete for, and win, political favors are ameliorated, and incentives for innovative lawmaking are enhanced.⁸¹

⁸⁰ Citizens signal their preferences respecting legal goods and services when they migrate from regime to regime. Their ability to exit disempowers government actors, whose welfare diminishes as citizens depart, taking along votes and revenues. See Ronald Daniels, *Should Provinces Compete? The Case for a Competitive Corporate Law Market*, 36 MCGILL L.J. 130, 142-43 (1991).

⁸¹ See ROBERTA ROMANO, *THE GENIUS OF AMERICAN CORPORATE LAW* 4-5 (1993),

Regulatory competition has been brought to bear on the entire range of federalism discussions, usually to support a devolutionary initiative or to oppose a proposal for federal intervention. This is because the law as product model implies a preference for decentralized regulation. It depicts central government as a cartel: Just as collaboration among competing producers of products reduces price competition and incentives to innovate, so the removal of regulatory subject matter to a central government reduces the number potential competitors and dilutes entrepreneurial incentives. Furthermore, since the revenue enhancement constraint on the national government is less intense,⁸² the national lawmaking process will be slower, less responsive to productive concerns, and more susceptible to the influence of organized interest groups.⁸³

Regulatory competition theory applies to corporate law on the assumption that state corporation codes are products for which reincorporating firms are the marginal consumers.⁸⁴ In the resulting description, competition for the legal business of firms forces the states to adapt the law to the dynamic conditions in which the firms operate. State lawmaking emerges as a trial and error process suited to the accurate identification of optimal corporate arrangements. More particularly, reincorporating firms seek a predictable legal regime that reduces their costs. Delaware, leading provider of charters, provides this with comprehensive case law, well-specified indemnification rules, and an expert judiciary.⁸⁵ The firms also seek a guaranty that the new state of domicile will maintain the desirability of its code — the reincorporating firm and the target jurisdiction enter into a relational contract that entails a risk of opportunistic breach. Even as the firm invests to gain access to the target's favorable legal regime, the target remains free to change its politics and transform itself into an unresponsive jurisdiction. The competitive jurisdiction has to reduce this possibility by offering a credible commitment. Delaware's commitment stems from its fiscal dependence on franchise tax revenues.⁸⁶ These revenues are an 'intangible asset' that emerges from the combination of a large number of incorporations and a small population. Delaware also invests in real assets specific to its incorporation business — its caselaw, and judicial and administrative expertise. These, together with Delaware's code, constitute reputational capital.⁸⁷ To protect the capital, Delaware imposes internal process and struc-

hereafter cited as ROMANO, GENIUS OF CORPORATE LAW.

⁸² *Id.* at 4-5, 48.

⁸³ *Id.* at 5.

⁸⁴ *Id.* at 6.

⁸⁵ *Id.* at 32, 33-34, 39 n.20.

⁸⁶ *Id.* at 36-37.

⁸⁷ The store of capital bolsters the state's market position. Other states cannot credibly

ture rules that deter political disruption.⁸⁸

As originally articulated, this market-based race to the top validation of state law bypassed the problem of the shareholders' lack of influence over state lawmaking with a reference to the control market deterrent. The assertion, in effect, was that the managers' option of exit adequately disciplined the states, while the possibility of shareholder exit by tender to a hostile offeror adequately disciplined the managers. This story lost its persuasiveness when managers and state politicians collaborated⁸⁹ to hamper the market deterrent with the antitakeover legislation of the 1980s.⁹⁰ This manifest case of charter market failure⁹¹ reinforced the assertion of the system's opponents that, despite its competitive elements, it still allows management to capture the states, with suboptimal results. Following the lead of Roberta Romano,⁹² the members of the market deterrent school moved to a middle ground position on charter competition.⁹³ There they defend the state system, except to the extent that

precommit to offer superior service, and thus are deterred from incurring the necessary start-up costs. A first mover advantage in Delaware results. *Id.* at 40-41, 43-44.

⁸⁸ These include its direction of corporate matters to a specialized chancery court, its practice of appointing rather than electing its judges and limiting them to twelve year terms, and its requirement of two-thirds majorities of both houses of its legislature for the approval of corporation code amendments. *Id.* at 38-42.

⁸⁹ Although this is interest group legislation, it did not result from the efforts of a centrally-organized management lobbying effort. Romano's case study of the state legislative process here suggested that the statutes are initiated by threatened managers of local corporations and their assistants in the local corporate bar rather than by broad coalitions of business, labor and community leaders. See Roberta Romano, *The Future of Hostile Takeovers: Legislation and Public Opinion*, 57 U. CIN. L. REV. 457, 461 n.11 (1988).

⁹⁰ For a summary see ROMANO, *GENIUS OF CORPORATE LAW*, *supra* note 81, at 53-57, 74-75.

⁹¹ A large body of empirical work confirms that the antitakeover statutes had a harmful effect on shareholder value. This empirical result emerges from a complex picture that encompasses the negative price effects of contractual antitakeover provisions such as poison pills. For a summary, see *id.* at 60-67.

⁹² See Roberta Romano, *Law as Product: Some Pieces of the Incorporation Puzzle*, 1 J. L. ECON. & ORGS. 225 (1985).

⁹³ See, e.g., Ralph K. Winter, *The Race for the Top Revisited: A Comment on Eisenberg*, 89 COLUM. L. REV. 1526, 1528 (1989) (expressing more confidence in incorrectness of the race-to-the-bottom view than in the view that state competition results in a race-to-the-top); FRANK H. EASTERBROOK & DANIEL R. FISCHER, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 222 (1991) (concluding that the race to the top stands as refuted, but the proposition that competition creates a 'powerful tendency' to enact shareholder beneficial laws remains vital).

it inhibits the control market. Other commentators, all of whom also occupy middle ground views, have taken the occasion to attack the state system and argue for federal intervention.⁹⁴ As usual, at the debate's bottom line lies the

⁹⁴ See Lucian Ayre Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1435, 1458-75 (1992). Bebchuk argues that the middle ground result stems from a structural defect in the competitive system that disables the production of a maximizing legal regime. The market leads the competing states to focus on the variables that influence reincorporation decisions. *Id.* at 1452, 1454. From this there follows a concern for management preferences rather than shareholder value itself. Accordingly, nothing deters the states from pursuing policies of management accommodation respecting the fiduciary and market deterrents. *Id.* at 1462-63, 1468, 1488. Bebchuk concludes that much state takeover regulation should be preempted and federal fiduciary standards should be imposed. *Id.* at 1495. See also David Charny, *Competition Among Jurisdiction in Formulating Corporate Law Rules: An American Perspective on the 'Race to the Bottom' in the European Communities*, 32 HARV. INT'L L.J. 423, 441-53 (1991); Joel Seligman, *The New Corporate Law*, 59 BROOKLYN L. REV. 1, 60-63 (1993); Joel Seligman, *The Case for Minimum Corporate Law Standards*, 49 MD. L. REV. 947, 971-74 (1990); Roberta S. Karmel, *Is It time for a Federal Corporation Law?* 57 BROOKLYN L. REV. 55, 91-96 (1991).

New allegations of interest group capture also have cropped up. See William W. Bratton and Joseph A. McCahery, *Regulatory Competition, Regulatory Capture, and Corporate Self-Regulation*, 73 N.C. L. REV. 1861 (1995), in which we argue that capture of corporate law by the management interest operates across the 50 states and that regulatory competition exacerbates the problem, producing corporate codes that block shareholder access to the corporate contract and justifying limited federal intervention. Our interest group capture story complements, and to some extent contrasts, with an antecedent description by Jonathan Macey and Geoffrey Miller. See Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469 (1987). Macey and Miller offer a supply side account that highlights the impact of internal interest group politics on the production of Delaware law. *Id.* at 471-72. In their account, all groups within the state have a common interest in producing a marketable legal regime, but the groups differ on the relative proportions of costs imposed and revenues earned. The taxpayers have an interest in higher direct costs (franchise tax revenues) and lower indirect costs (legal fees). The lawyers' interest in fees would be served by lower direct costs leading to a greater number of incorporations, and by higher indirect legal costs even at the sacrifice of some incorporations to the extent that the legal fees paid exceed those lost. Macey and Miller assert that, unlike Delaware, a state acting as a pure profit maximizer would limit indirect costs so as to maximize direct costs. *Id.* at 472-73, 498, 503-04. Delaware fails to conform to the product model's predictions because the bar acts as a small, cohesive interest group that extracts special concessions from the legislature at the expense of the general public. *Id.* at 504-08. For an extension of this story to the broader context of choice of law, see Larry E. Ribstein, *Delaware, Lawyers, and Contractual Choice of Law*, 19 DEL. J. CORP. L. 999 (1994), hereafter cited as *Ribstein III*.

allocation of the theoretical burden of proof for or against federal intervention.

Theoretical burdens of proof also show up at the bottom line when regulatory competition theory is drawn on to explain the proliferation of LLC statutes. The inclusion of regulatory competition in the account of events supports an inference of productivity, countering the negative signal sent by the pro rata theory of limited liability.

B. Domestic Incentives: LLCs in an Island Jurisdiction

Hypothesize an island jurisdiction that makes available the corporate, limited partnership, and partnership business forms, and taxes income pursuant to a system identical to our federal tax system. Assume that the taxing authority issues a new ruling that makes one-tier taxation available to an incorporated partnership. The question is whether the island state's legislature can be expected to respond by enacting an LLC statute. Assume further that the efficiency of the statute follows from a relatively simple cost-benefit comparison: The costs are the costs of externalized firm torts and the benefits stem from cost savings accruing to firms organizing as LLCs and new capital formation induced by the form's availability. Finally, make the public choice assumption that the legislature is open to the influence of special interests and routinely enacts suboptimal legislation in order to meet their demands and preferences.

1. Beneficiary Firms

Legislative authorization of LLCs holds out potential cost-saving benefits for several classes of firms.⁹⁵ The first class is made up of existing partnerships for which incorporation is unduly costly due to the costs and uncertainties of planning within the corporate form and Subchapter S. The second class of firms contains existing Subchapter S corporations for which long term cost savings accrue in the event of reorganization as LLCs, with the savings

⁹⁵ We stress the word 'potential'. The pattern of LLC usage in practice appears to be more complex than one would predict based on an encounter with the cost saving claims of LLC enthusiasts. For example, start up firms in which venture capitalists invest continue to choose the corporate form, despite the two-tier tax treatment thereby entailed. See Joseph Bankman, *The Structure of Silicon Valley Start Ups*, 41 U.C.L.A. L. REV. 1737, 1747-50 (1994). For a governance-based explanation, see Deborah A. DeMott, *Agency and the Unincorporated Firm: Reflections on Design on the Same Plane of Interest*, __ WASH. & LEE L. REV. __ (1997).

exceeding the cost of reorganization.⁹⁶ The third class consists of future firms which, but for the LLC statute, would fall into one of the first two classes.

Three additional classes of beneficiary firm can be suggested, but on a more speculative basis. The first contains future firms that come into existence in the LLC form that would never have come into existence had the form not been available. The number of firms falling into this category is likely to be quite small. To the extent that limited liability and one-tier tax treatment are preconditions to these firms' existence, Subchapter S incorporation would be available in any event at additional cost. The class thus contains only firms for which the cost savings held out by the LLC has a magnitude sufficient to induce new capital formation. We suspect that, given a project of a value so marginal that the cost of Subchapter S organization presents an insuperable barrier, the nontrivial costs of organizing as an LLC also will present a significant deterrent. A second and related class of beneficiaries consists of existing and future C corporations that prefer one-tier tax status obtainable only through the LLC form. This class, by definition, falls outside of the Subchapter S limitations, presumably due to a large number of equity participants. Such a large base of equity participants also would tend to preclude selection of the partnership form. Presumably, the number of firms in this class also is very small, since the defining characteristics make the firms likely candidates for organization as limited partnerships. With that point we identify a final class of beneficiary firms — present limited partnerships for which long-term cost savings will accrue in the event of reorganization as LLCs, with the savings exceeding the cost of reorganization. Future firms that, but for the LLC statute, would have organized as limited partnerships also fall into this class.

2. Costs and Benefits

The beneficiaries of the legislation having been identified, we can proceed to consider the island jurisdiction's cost-benefit calculation. An LLC statute will be Kaldor-Hicks efficient if the externalities suffered and additional costs incurred as the result of its employment are so trivial as to be outweighed by the quantum of benefits from cost savings to firms and spillovers from

⁹⁶ Larry E. Ribstein, *Statutory Forms for Closely Held Firms: Theories and Evidence from LLCs*, 73 WASH. U. L. Q. 369, 428-30 (1995), hereafter cited as *Ribstein IV*, collects numbers for organizations in the LLC, limited partnership, and corporate firms in five states during the period 1988-1994. Ribstein interprets the numbers to support an inference that actors have been switching from the corporate and limited partnership form to the LLC form. *Id.* at 429.

incremental capital formation accruing within the state. But, for the sake of discussion, we will make a contrary cost-benefit assumption here — that is, the costs externalized and incurred as the result of the increase in the number of limited liability businesses are not trivial. From this point there ensues a complex cost-benefit comparison. Clear benefits accrue, first, from the cost savings yielded for existing Subchapter S firms and, second, from spillovers from new businesses that otherwise would not be formed. Things become less clear, however, when we turn our attention to the class of partnerships that reorganize under the LLC statute. Here we have two additional categories of social cost to consider. These businesses presumably will incur additional transaction costs as they pursue limited liability as LLCs. Also, since these firms are new to limited liability, it is possible that LLC status will alter their incentives so that they now engage in suboptimally risky new lines of business. By analogy, a technical innovation that lowers the cost of evading detection for criminal conduct leads to no overall gain for society. Accordingly, as to this class of firms, any benefits result only from the productive aspects of new lines of business taken up after reorganization as LLCs that would not have been taken up had LLC organization been unavailable.

So as to raise with clarity the political issue implicated by LLC legislation, we will stipulate a cost-benefit result: The enactment of the LLC statute is inefficient. Accordingly, if the public interest is the state legislature's sole concern, there will be no LLC statute. But since public choice assumptions are made here, the question as to enactment remains open.

3. *Interest Groups*

Will the island state's legislature enact an LLC statute? Projection of an answer to this question requires us to specify the interests pro and con and to project their likely influence on legislative results.

First and foremost on the pro side come the business lawyers. They have a high-powered incentive to persuade the legislature to enact the statute in order to increase fee revenues. There appears to be one-period pent up demand that they can satisfy⁹⁷ stemming from existing inventory of partnerships, limited partnerships and corporations that will opt to transfer to LLC status. In subsequent periods, the lawyers presumably gain to the extent that new firms that otherwise would organize as partnerships choose the more formal, and expens-

⁹⁷ See Jennifer G. Brown, *Competitive Federalism and Legislative Incentives to Recognize Same-Sex Marriage*, 68 SO. CAL. L. REV. 745, 747-69 (1995).

ive, LLC form, and also to the extent of new capital formation. But the lawyers will lose to the extent that firms that otherwise would organize as more expensive corporations or limited partnerships choose the LLC form.⁹⁸ The lawyers will have no problem in mobilizing to procure the legislation. Their bar associations routinely step in to solve problems of collective action respecting enactment of beneficial legislation, serving the drafting function as well as the lobbying function.⁹⁹ Organized small business interests conceivably could join the lawyers in the lobbying process. Both voices, thus organized, would serve as a proxy for the voice of any present and potential outside investors in small firms.

There are three possible voices that might be heard on the opposition side. The first is the state treasurer, to the extent that LLC implies revenue losses. The extent of any such loss would not appear to be particularly significant, however. Any income tax consequences would be trivial because most corporate candidates for LLC reorganization presumably already would be Subchapter S taxpayers and one-tier treatment also will have been the rule for all partnership and limited partnership candidates for LLC formation.¹⁰⁰ Nor should the franchise tax draw present a problem: If franchise taxes for LLCs are set at a level comparable to that already existing for close corporations, the treasurer should experience a net gain as untaxed partnerships convert to LLC form and become franchise taxpayers. The second candidate for the opposition role is the banks. To the extent that limited liability presents a contracting barrier, the statute will disable them from contracting back to their *ex ante* position of security respecting small business lending.¹⁰¹ But since they can adjust the cost of credit to make up for this and diversify the additional risk, one would not expect them to expend financial resources and political capital on an opposition campaign.¹⁰² The third potential class of objectors is the

⁹⁸ We have heard informally from practitioners in two different states that the LLC form is most widely employed for single-purpose real estate acquisition vehicles having a single equityholder. With the LLC, counsel can just file a piece of paper, skipping the additional step of producing a needless set of by-laws.

⁹⁹ Cf. William J. Carney, *Federalism and Corporate Law: A Non-Delaware View of the Results of Competition*, in WILLIAM BRATTON, ET AL, INTERNATIONAL REGULATORY COMPETITION AND COORDINATION: PERSPECTIVES ON ECONOMIC REGULATION IN EUROPE AND THE UNITED STATES 157-61 (1996).

¹⁰⁰ Moreover, if the Silicon Valley experience is any guide, some potential LLCs will organize as C corporations despite the tax disadvantage. See *supra* note 95.

¹⁰¹ Booth, *supra* note 29, at 157-61.

¹⁰² Contract creditors unaware that firms were shifting to limited liability status in quantity might suffer surprise losses. See Saul Levmore, *Partnerships, Limited Liability Companies*,

tort plaintiffs' bar. Here participation in the political process would depend on a cognizable division of labor¹⁰³ between business lawyers and plaintiffs' litigators. Even given such a division of labor, the business lawyers would appear to have the more high-powered incentive. They would be going after the near-term reward of fees generated by pent-up demand. In contrast, income reductions to the plaintiffs' lawyers stemming from the difficulty of collecting judgments against LLCs amount to a distant period problem and, as a result, may take on a speculative appearance in the present. Indeed, the likelihood of loss might rationally be discounted on a number of grounds. Individual defendants could be identified in many cases,¹⁰⁴ and the remedy of veil-piercing might provide some compensation.¹⁰⁵ In addition, to the extent that the expansion of limited liability attracts assets to risky endeavors, the volume of tort litigation will rise, with recoveries out of corporate assets in those cases offsetting losses from unsatisfied judgments in others. Finally, since the incentives of the tort plaintiffs' bar have themselves become a political issue, a perceived need to husband political capital for opposition to more threatening future legislative initiatives might counsel silence here, even given a perceived impairment of interest. In all, then, the organized plaintiffs' bar serves as a decidedly imperfect proxy for the interest of inchoate class of future tort victims. It accordingly is plausible to project complete silence respecting the tort victim interest in the political process respecting LLCs.

4. *Predicted Result*

Comparison and weighing of the competing interests, thus described, supports a projection of prompt enactment of an LLC statute. Here we tell a 'just so' story, of course. The historical proliferation of LLC legislation has been attributed to the initiative of state bar committees rather than the initiative of the legislators themselves.¹⁰⁶ State treasurers, if they have objected behind the scenes, have been overruled. The banks and the plaintiffs' bars appear to

and Taxes: A Comment on the Survival of Organizational Forms, 70 WASH. U. L. Q. 489, 491-92 (1992). Obviously creditors so positioned would not be players in a political process.

¹⁰³ Note that a complete division of labor among individual business lawyers and tort litigators need not result in a visible division of interest on the part of the bar if the two types of lawyers practice together in firms.

¹⁰⁴ See Booth, *supra* note 29, at 154-57.

¹⁰⁵ See Ribstein I, *supra* note 7, at 8-9 (suggesting that corporate veil piercing on general equitable principles should apply equally to LLCs).

¹⁰⁶ *Id.* at 4. See also Ribstein III, *supra* note 94, at 1008-12 (explaining that in 'non-corporate' situations holding out no cognizable franchise tax yield for the state, its legislators will not have incentives to innovate).

have taken no interest in the matter. Thus, in practice, the business lawyers' high-powered incentives appear to have carried the day.

Note that in our hypothetical island state the law of business forms very much is product — domestic product. The local bar procures the legislation in order to access and satisfy an existing client demand. Yet, significantly, nothing in this law as product description provides the slightest assurance that the legislation is efficient. Indeed, in the confines of the model here, the supply-side interest procures the legislation in the usual manner of interest group capture and the demand being satisfied stems in part from a perverse incentive to externalize accident costs.

It also should be noted that the alignment of incentives in the island state make it likely that innovation respecting the terms of the LLC form will continue in the period following enactment. The legal practitioners can only learn the particulars of the statute's effects on a trial and error basis over time. As they do so, one would expect to see amendment of the legislation. This, presumably suboptimal, incentive to innovate follows from the business lawyers' interest in maximizing fee revenues. Recall that one of the main sources — perhaps even the primary source — of fee revenues from LLC organization lies in firms that, but for the LLC statute, would organize as partnerships due to the prohibitive costs and uncertainties attending corporate organization under Subchapter S. There arises an implication of extreme cost sensitivity on the part of these firms: Limited liability has a value to them, but they opt in only if the cost is minimal. Given such discriminating consumers, we can expect the business bar to invest in close monitoring of the operation of the LLC statute. Since complexity is involved, there is no reason to expect that the bar association's (and legislature's) first round draft will best satisfy client demand. Rounds of revision will be needed to achieve the maximum possible satisfaction of client demand for lowest cost organizational terms. As the statute is improved through amendment, the class of firms for which LLC organization expands, with the bar experiencing the reward of higher revenues. Here again we tell a 'just so' story: The prevailing forms of LLC statutes have evolved dynamically in the course of their short history.¹⁰⁷

¹⁰⁷ See Ribstein IV, *supra* note 96, at 412-28.

C. Incentives to Race-to-the-Bottom: LLCs in a Federal System With a Rule of *Siège Réel*

It has been suggested that the states' rapid movement to enact LLC statutes cannot be described as a race-to-the-bottom for the reason that a downward corporate race can only occur given a separation of ownership and control.¹⁰⁸ Unfortunately, this suggestion misses the point. If a given legislative enactment causes costs to be incurred in other states, then a race-to-the-bottom always is a structural possibility. Thus, to the extent that the costs of limited liability are felt outside of the state providing the business form, a race-to-the-bottom could occur when multiple states expand the availability of limited liability.

We model such a race to externalize below. The pattern of regulatory competition that informs the model follows from conditions quite distinct from those that determine the familiar corporate law race of charter-mongering jurisdictions. To underscore this difference, our model assumes a federal system in which charter-mongering is precluded by a *siège réel* choice of law rule. In other words, firms must be chartered in the state in which most of their assets are situated. Although the exercise shows that a race-to-the-bottom is a structural possibility, we conclude that this theoretical race is very unlikely to have figured into the proliferation of LLC statutes across the states.

1. Regulatory Races to the Bottom — Externalities, Preferences, and Prisoners' Dilemmas

Regulatory competition theory recognizes two exceptions to its presumption favoring state-level lawmaking. First, the federal government has to keep state borders open if factor and citizen mobility is to bring competitive discipline to regulation at the state level.¹⁰⁹ Second, pursuant to the command that the scope of regulation should match the domain of its costs and benefits, the federal government has to police interstate externalities.¹¹⁰ Competing governments have an incentive to regulate so as to facilitate cross-border cost externalization by their citizens. This occurs, for example, when a jurisdiction makes an exception in its environmental law for a given type of pollution knowing that prevailing winds blow the permitted particles across the border. Here, not only does the producer externalize a cost, but those affected by the

¹⁰⁸ See Macey, *supra* note 13, at 442-43.

¹⁰⁹ Frank H. Easterbrook, *Federalism and European Business Law*, 14 INT'L REV. L. & ECON. 125, 129 (1994).

¹¹⁰ *Id.* at 127.

externality have no voice as to its regulation and get no chance to trade sufferance of the pollution for higher incomes.

Cross-border externalities, then, invite races-to-the-bottom across multiple states, with either of federal intervention or interstate governmental cooperation being justified as a remedy.¹¹¹ Choice of law behavior in products liability litigation has been argued to present such a case.¹¹² The key to this argument, as articulated by Michael McConnell, lies in the problem of synchronizing local preferences respecting levels of product liability with supply and demand conditions in a national product market. Since each state's manufacturers price and sell on a national basis, individual states have an incentive to set a higher level of product liability protection than they would set as island jurisdictions. The federal system thus allows them to satisfy local plaintiffs at the expense of foreign manufacturers, free riding on states that legislate lower levels of protection. Downward adjustment of the level of liability does local manufacturers little good, and forces local plaintiffs to incur the cost of finding alternative jurisdictions in which to sue. Says McConnell, we accordingly tend to see downward adjustments of liability levels only where costs and benefits both are felt locally — medical malpractice and municipal liability being examples. With products liability, he argues, the downward race to set high levels of liability requires federal level adjustment.¹¹³

Races to externalize, such as that hypothesized by McConnell, comprise a subset in the range of race-to-the-bottom situations debated in the literature. Some important points of distinction should be noted. Consider, by way of contrast, the famous race-to-the-bottom argument advanced to justify the federalization of environmental law.¹¹⁴ That argument presupposes no cross-

¹¹¹ Richard B. Stewart, *Environmental Regulation and International Competitiveness*, 102 YALE L. J. 2039, 2098 (1993).

¹¹² See Michael W. McConnell, *A Choice-of-Law Approach to Products Liability Reform*, in NEW DIRECTIONS IN LIABILITY LAW (W. Olson ed., 1988). See also Michael E. Solimine, *An Economic and Empirical Analysis of Choice of Law*, 24 GA. L. REV. 49 (1989). But cf. Bruce L. Hay, *Conflicts of Law and State Competition in the Product Liability System*, 80 GEO. L. J. 617, 617-18, 651-52 (1992) (arguing the states have a dual incentive — to attract investment with manufacturer-favorable liability rules and to skew their choice of law rules in directions favorable to individual local plaintiffs suing foreign manufacturers — and that therefore the incentive picture is more complicated than in McConnell's presentation and counseling caution respecting federalization of the product liability system).

¹¹³ McConnell, *supra* note 112, at 91-92.

¹¹⁴ See, e.g., Richard B. Stewart, *The Development of Administrative and Quasi-Constitutional Law in Judicial Review of Environmental Decisionmaking: Lessons from the Clean*

border pollution. It instead focuses on the internal state politics of environmental regulation, asserting that local factors of production exercise a distortive influence when they threaten to relocate in the wake of stepped up regulation. The argument is that competition for new factors of production among the states leaves them in a prisoners' dilemma respecting environmental standards. Each state is deterred from promulgating standards at its preferred level of strictness by the threat of a loss of production factors to a defecting competing state. The more intense the competition for factors, the greater the disparity between the level of environmental protection desired by the public and that evolving in practice. Furthermore, given a large number of states, the transaction costs of collective action will prevent coordination. The prisoners' dilemma accordingly ripens into a commons dilemma calling for a federal level solution.¹¹⁵

Regulatory competition proponents have mounted a strong attack on the assumptions underlying this prisoners' dilemma story. The prisoners' dilemma set up, they say, depends on the assumption that the multiple jurisdictions have fixed preferences for strict regulation, each believing that the subject matter should not be one for cost-benefit tradeoffs. Competition for factors and collective action problems then undermine the jurisdictions' ability to adhere to the stated policy, leading to a suboptimal result.¹¹⁶ A more realistic set up, say the critics, would depict the situation differently: In a world of scarce resources, cost-benefit tradeoffs between levels of regulation and income are inevitable; no *a priori* fixed preference for a given level of regulation should be assumed. Without fixed preferences across jurisdictions, higher payoffs through federalization or interstate cooperation cannot be assumed and a prisoners' dilemma is not inevitable. While it is in theory possible that absolute, normatively-based preferences, whether for stricter environmental rules or some other form of regulation, could exist across jurisdictions, this is

Air Act, 62 IOWA L. REV. 713, 714-22 (1977); Richard B. Stewart, *Pyramids of Sacrifice? Problems of Federalism in Mandating State Implementation of National Environmental Policy*, 86 YALE L. J. 1196, 1212 (1977).

¹¹⁵ Revesz restates the prisoners' dilemma account in a two-party framework, showing that where a player has two strategies, lax and strict, a suboptimal lax strategy will strongly dominate the optimal stringent strategy. Richard Revesz, *Rehabilitating Interstate Competition: Rethinking the 'Race-to-the-Bottom' Rationale for Federal Environmental Regulation*, 67 N.Y.U. L. REV. 1210, 1216-17, 1229-32 (1992). The suboptimal lax strategy is a unique equilibrium and will always be selected. Note also, that given 50 states, co-operation through mutual forbearance is unlikely to evolve even given infinite repetition of the game. Hay, *supra* note 112, at 625-26.

¹¹⁶ Revesz, *supra* note 115, 1219-24.

asserted to be very unlikely as a practical matter.¹¹⁷

A prisoners' dilemma characterization remains structurally appropriate, however, in cases where negative externalization drives the lawmaking strategy.¹¹⁸ The model that follows falls into this category.

2. *Racing to Externalize With Limited Liability*

a. *Low trade scenario*

We begin with the island jurisdiction of the previous subpart. As before, larger firms endure two-tier taxation but enjoy limited liability. For simplicity, we assume that all smaller firms are organized as partnerships because of the high expense of incorporation. We also drop our public choice assumption and instead stipulate that the jurisdiction's government devotes itself to the maximization of the welfare of its citizens. The jurisdiction has altered its income tax regime to extend the availability of one-tier taxation and now its legislature has to decide whether to enact an LLC statute. The legislature correctly ascertains that the value of the present system of small firm unlimited liability to be 100 — the sum of the value of extra compensation to tort victims, transaction cost savings, and foregone investment in unproductively risky ventures. The cost of this unlimited liability system is 80 — the sum of the negative value of foregone investment in productive ventures and the dead-weight extra costs incurred by a firms that incorporate but would not do so in a regime making limited liability more cheaply available. On these numbers, the legislature, immune as it is to the ministrations of interest groups, will not enact an LLC statute.

Now let us change the facts and place the island jurisdiction in a federation of four identical states. As stated, the rule of *siège réel* prevails. But, as in our interstate corporate system, each must recognize corporations formed in each other state. Trade and interstate contact are spread evenly across the jurisdictions' geographies and are enjoyed on a *pro rata* basis by all firms. The level of trade is such that some of the benefits of each state's unlimited liability regime are felt in other three states. Specifically, 90 percent of the benefits accrue to local residents and firms, while 10 percent of the benefits accrue to out-of-state residents and firms. All of the costs of the regime are incurred by

¹¹⁷ Stewart, *supra* note 114, at 2058-59. For a strong rebuttal, see Brian A. Langille, *Competing Conceptions of Regulatory Competition in Debates on Trade Liberalization and Labour Standards*, in BRATTON, ET AL, *supra* note 99, at 477-90.

¹¹⁸ See Hay, *supra* note 112 at 625-26.

local businesses and citizens. Since the legislature of each state cares only about the welfare of its own citizens, the externalized benefits have no bearing on the legislative cost-benefit calculation. Yet no shift in favor of LLCs results on these numbers. Although the costs of an LLC statute now amount to only 90 of foregone benefits of unlimited liability, the LLC statute's benefits remain fixed at 80. Since we are in a world of *siège réel*, no state's preference calculation can be influenced by the possibility of setting up shop as a charter-monger that draws benefits from pent up demand for LLC status across the four states. If any one state enacts an LLC statute, foreign corporations wishing to take advantage literally will have to pick up stakes and move their assets. Such capital movement seems unlikely, since incorporation is available in each of the four states for any firm willing to pay the incremental cost.

b. Significant trade scenario

Now let us examine the incentives of each of the four states on a different scenario. We go from a low trade scenario at $t = 0$ to a $t = 1$ at which interstate trade has picked up substantially and makes up a more significant proportion of the gross product of each state. The increased level of trade is such that 70 percent of the benefits of unlimited liability are felt at home and 30 percent are felt outside, distributed as an even 10 to each other state. As before, all costs of unlimited liability are felt at home by local businesses.

Assume further that State 1 fortuitously adjusts its corporate tax system at $t = 1$ to make one-tier treatment available to all small firms whatever their form and, as a result, rethinks its policy respecting limited liability. State 1 has a short-term incentive to take the first mover role respecting an LLC statute. The local benefits of unlimited liability are 70 and costs are 80. And, since the benefits of unlimited liability are the costs of limited liability, the state can export 30 percent of the costs of the shift, provided of course that none of the other states make the same move.

State 1 thus enacts an LLC statute at $t = 1$. We now look at the situation from the point of view of the legislature of State 2 at $t = 2$. State 2 is experiencing 70 of benefits from unlimited liability and bearing 80 of costs. In addition, it bears 10 of additional costs of limited liability exported by State 1. Standing pat thus leaves State 2 in loss situation. If it enacts an LLC statute it will receive benefits of 80, incur local costs of 70 and export 30 of costs to the other three states. Of those exported costs, 10 will go to State 1, offsetting the 10 of costs coming from State 1. Netting all of this out, an LLC statute will be a wash for State 2, yielding 80 of benefits against 70 of local costs and 10 of costs coming from State 1 in any event. If States 3 and 4 do not act, enactment of the LLC statute is the maximizing move for State 2.

The problem, of course, is that States 3 and 4 are doing the same analysis at $t = 2$. If all three states enact LLC statutes they will get the following result: Each of the four states will gain 80 in benefits of limited liability, incur 70 of local costs, export 30 of costs, and import 30 of costs, for a total cost of 100. This situation clearly is suboptimal, since as island jurisdictions none would prefer the limited liability regime. Absent an opportunity for coordination across the states, this also would appear to be the equilibrium result, since each of States 2, 3, and 4 has a sucker payoff to worry about. If, say, State 2 stands pat and States 3 and 4 enact LLC statutes, it ends up in a worst case situation, experiencing 70 in local benefits, 80 in local costs and an additional 30 in costs exported from the other States for a total cost of 110. On the other hand, if coordination among the states is feasible, States 2, 3 and 4 could mutually agree to stand pat.¹¹⁹ This leaves each with 80 of benefits and 90 of costs for a deficit of 10 — a result superior to the deficit of 30 resulting from uncoordinated enactment of LLC statutes. Of course, if the agreement to stand pat cannot be enforced, there will remain an incentive to defect on the part of each state so as to pick up 10 of benefits. The first-best result, however, comes only as the result of intervention by the federal government to bar all four states from extending the availability of limited liability.

A question arises about the incentives of the first mover, State 1. Given that its initial adoption of an LLC creates the possibility of a suboptimal equilibrium at $t = 2$, why would it move in the first place? Two reasons can be suggested. First, the time lapse between the first and second periods might be long, given information asymmetries and the vagaries of political processes — long enough to make first movement optimal given a high discount rate on the part of State 1's politicians and the possibility of interstate coordination in a later period. Second, if State 1 is lucky, States 2, 3, and 4 will coordinate themselves into standing pat, leaving State 1 on a first-best free ride.

c. Imbalanced trade scenarios

Let us try one further scenario to illustrate the possibility that State 1 can succeed with a scheme to externalize. All we have to do is give State 1 a special reason to take the first mover role. Specifically, State 1 contains the federation's largest city and business center. As a result, the benefits of limited liability to State 1 are 100 where the benefits remain at 80 in the other states. On these numbers, there is no reason for State 1 either to refrain from enacting an LLC statute or to cooperate with the other states.

¹¹⁹ The stand pat result also might emerge as a focal point equilibrium.

We get a variation on this theme if we stipulate benefits of limited liability at an even 80 across all four states, but then accord State 1 a 70-30 split between internal and external benefits, and accord each of States 2, 3, and 4 a 90-10 split between internal and external benefits. That is, citizens from States 2, 3 and 4 go to the big city in State 1 to do business, but the volume both of citizens going out of State 1 to do business and the volume of traffic between the other three states *inter se* is much lower. On these numbers, State 1 has every incentive to externalize. At $t = 2$, if each of the other states stands pat, each will have an unlimited liability benefit of 90, a local unlimited liability cost of 80, and an externalized cost of 10 that it cannot avert. If the states enact LLC statutes, they will each have a limited liability cost of 90, a limited liability benefit of 80 plus a burden of externalized costs in excess of 10, assuming that each spreads some of its trade around the group of 3.¹²⁰ Doing nothing thus is the superior strategy, and State 1's move does not prompt a race-to-the-bottom.

3. Summary

Generally, then, the higher the level of interstate contacts and trade, (a) the wider the spread between the benefits and costs of liability and unlimited liability in each state, and (b) the more likely it is that a given state will have an incentive to move to a limited liability regime from a first position of unlimited liability in order to effect externalization of the costs of limited liability. Given such a first move, a race-to-the-bottom among the remaining states in the federation may or not ensue, depending the cost-benefit posture of each state.

That all having been said, it appears very unlikely that desire to externalize costs of limited liability on the part of individual states has played a causative role in the proliferation of LLC statutes. Since we tend to deal with small firms here, we also deal for the most part with local costs and benefits. The posture might be different if the subject was an extension in of the availability of limited liability for the benefit of large corporations doing business in the national market.

¹²⁰ And even if each of the three states does all of its trading with State 1, the enactment of an LLC statute still leaves it in a negative situation with costs of 100 and benefits of 80.

D. Incentives to Race-to-the-Top: LLCs in a Federal System

We begin with the hypothetical federal system of the previous subpart and change a number of assumptions. First, we abandon the rule of *siège réel*, making it possible for firms to incorporate in any state despite the location of their assets elsewhere. Second, we revert to the public choice framework and assume that there obtains in each state the interest group alignment described above for an island jurisdiction. Third, we initially assume that there is no uncertainty respecting recognition of foreign LLCs in any state in the federation (an assumption we later relax).¹²¹ And, fourth, we add a fifth state modelled on Delaware: State 5 is smaller in area and population than the other four and has made a successful business of attracting the chartering business of large, publicly-held firms. We look at the five jurisdictions at three times. First comes $t = 0$, when the federal government alters its tax system to allow one-tier treatment for incorporated firms matching the description of LLCs; second comes $t = 1$, some years later, when all five jurisdictions have LLC statutes; third comes the period after $t = 1$ and before a $t = 2$ that occurs several years later still. Here is the question for discussion: Whether there is any basis to for concluding that regulatory competition plays a significant causative role either in the first appearance of an LLC statute immediately after $t = 0$, in the proliferation of LLC statutes between $t = 0$ and $t = 1$, or in the ongoing maintenance and modification of the LLC regime between $t = 1$ and $t = 2$.

1. Corporate Charter Competition as a Model for the Period Between $t = 1$ and $t = 2$

We will begin with the period between $t = 1$ and $t = 2$ and inquire as to the likelihood that the pattern of corporate law charter competition will be replicated with respect to LLCs. Historically speaking, charter competition began after general incorporation statutes already had proliferated across the states — in effect *ex post* $t = 1$. We accordingly begin with the end period as we explore the possibility of direct application of the corporate charter competition model to LLCs. Under the charter competition model, State 5 would take the first mover role respecting improvements in the LLC form, amending its LLC statute with a view to attracting registration fees and legal business from the

¹²¹ Here we assume away a possible barrier to regulatory competition respecting LLCs. LLC proliferation in the federal system occurred despite a slight degree of uncertainty respecting recognition of foreign firms. See Larry E. Ribstein, *Choosing Law By Contract*, 18 J. CORP. L. 245 (1993).

other four states.

The question as to whether we plausibly can project replication of this charter competition pattern in the LLC context can be asked in two forms, one narrow and the other broad. The narrow question is whether we can expect a literal repetition. It admits of a clear answer: No. Two reasons can be cited, one lying on the supply-side and other on the demand-side: State 5's government has little financial incentive to compete for LLC business; at same time, costs constrain the migratory options of small firms suited to organization as LLCs. The broad question is whether, despite the absence of conditions supporting literal repetition, some out-of-state LLC business may find its way to State 5, with actors in the state having incentives to shape its legal environment so as to attract that business. Here a more equivocal answer is yielded: Possibly.

a. The narrow question

We address the question about exact replication by looking first at the supply-side incentive picture. Firms opting to become LLCs tend to be small firms, and small firms have historically been excluded from descriptions of charter competition. Close corporation charters, even when registered in quantity, provide only insignificant revenues to the chartering state. Delaware keys its franchise tax rates to the size of the chartered firm. The resulting revenue figures for close corporations are so small as to contribute only a minor portion of the state's revenue draw.¹²² The Delaware legislature, accordingly, has only a weak financial incentive to compete for small firm business.

The charter competition analogy also fails to carry over to the demand side of the incentive picture. As noted above, firms reincorporate to Delaware to obtain comprehensive case law, well-specified indemnification rules, and an expert judiciary.¹²³ Historically, these benefits have justified the costs of the move in the case of larger firms, either because they plan merger and acquisition transactions or, more generally, have a concern about shareholder litigation.¹²⁴ Since small firms have only a limited need for these services, they historically have tended to find that the costs of foreign incorporation outweigh the benefits. Nothing in the nature of the LLC provides a basis for a different projection. One would expect a strong incentive for foreign organization to arise only if a given home state provided a negative incentive, whether because

¹²² See Carney, *supra* note 99, at 156.

¹²³ See *supra* note 94 and accompanying text.

¹²⁴ See generally, ROMANO, *GENIUS OF CORPORATE LAW*, *supra* note 81, at 37-48. See also Macey, *supra* note 13, at 444-46 (arguing that LLCs do not replicate the corporate fact pattern).

it enacted a statute that failed to meet the demand of local firms in some material respect or failed to enact any statute at all. And even these cases, it would not be immediately clear that the costs and benefits favored foreign organization as an LLC. Recall, from the demand picture set out above for an island jurisdiction, that we for the most part deal here with a class of small firms as to which the costs of Subchapter S corporate organization loom so large that unlimited liability in the partnership form is the preferred alternative. The degree of transaction cost sensitivity thereby implicated makes foreign organization an unlikely first choice even in the case of a suboptimal domestic statutory provision. Incorporation in a foreign state costs the firm more because it results in two franchise taxes and two sets of compliance costs instead of one.¹²⁵ Whatever the benefits held out by a superior foreign codes and dispute-resolution regimes, they have not historically outweighed the costs with respect to close corporations. This demand side pattern should continue to obtain with LLCs.

The failure of the strict charter competition analogy should come as no surprise to anyone familiar with charter market's structure. Although it is fair to speak in terms of a charter 'market', that market does not function as a sort of Middle Eastern *souk* in which 50 states set up booths in a small space and corporate consumers go from booth to booth comparing product quality and haggling over price. Instead, only one state, Delaware, competes for charters on a national basis. Its capture of about half of the available volume has enabled it to develop an expertise in sophisticated corporate dispute resolution that cannot easily be replicated by a competitor.¹²⁶ Given convergence among the states as to the terms of corporate codes, the possibility of easy replication of any statutory innovations by Delaware, and the difficulty and expense of replicating Delaware's dispute resolution expertise,¹²⁷ no other state has had an incentive to invest in entry into active competition. Thus, interest group influence in the separate states, rather than regulatory competition, can be drawn on to provide an explanation for the phenomenon of fast diffusion of innovative code provisions across the states.¹²⁸

¹²⁵ The firm also opens itself to suit in two states instead of one. Ayres, *supra* note 99, 374-75.

¹²⁶ See Bratton and McCahery, *supra* note 94, at 1893-95.

¹²⁷ Cf. Ian Ayres, *Supply-Side Inefficiencies and Competitive Federalism: Lessons from Patents, Yachting, and Bluebooks*, in BRATTON, ET AL, *supra* note 99, at 241-46 (suggesting that the absence of intellectual property protection for innovators will lead to suboptimal charter competition).

¹²⁸ Carney, *supra* note 99, at 172-82.

b. The broad question

The absence of conditions necessary for replication of the corporate charter market does not imply the complete absence of competitive behavior respecting LLCs in the period after $t = 1$. To the extent that firms with substantial capitalizations choose the LLC form, it is not implausible to project that lawyers in State 5, the Delaware in our hypothetical federation, can succeed in skimming a little cream from the other states.

In making this projection, we look to Delaware's bench and bar for supply side incentives. The Delaware bench maintains a national reputation as a center for resolution of complex business disputes, and the Delaware bar draws rents from the resulting flow of litigation business.¹²⁹ LLCs, taken by analogy to close corporations, could provide some additional litigation volume. Some out-of-state close corporations do organize in Delaware, despite the standard cost-benefit recommendation against Delaware situs for small firms.¹³⁰ And a cognizable number of cases respecting Delaware close corporations have been reported over the decades.¹³¹ These firms thus add value to the state even though they do not contribute a substantial portion of its franchise tax draw, and there is every reason to expect the Delaware bar to pay close attention to the shaping and reshaping of the state's LLC statute with a view to catching any parallel LLC business. This is not a high-powered incentive — here any present investment in legislative drafting looks toward a speculative and

¹²⁹ State policy to expand the volume of this business is manifested in Delaware's contractual choice of law statute, DEL. CODE ANN. tit. 6, § 2708(a), (c) (1993). For discussion, see *Ribstein III*, *supra* note 94, at 1003-1007.

¹³⁰ This point is strongly implied by raw numbers of Delaware incorporations. In 1994, for example, there were 44,762 new incorporations in Delaware, Joe Fulgham and Kimberly Quillen, *Keeping Businesses in Delaware*, DEL. BUS. REV., Dec. 4, 1995, at 1; in 1996 the total number of active Delaware incorporations was 270,000, Kimberly Quillen, *Entrepreneurial Woman of the Year: Carolyn E. McKown*, DEL. BUS. REV., Oct. 28, 1996, p. 2. No doubt a large number of these firms were not out-of-state close corporations. They might, for example, be either of (a) publicly-traded firms organized in other states migrating to Delaware, (b) subsidiaries of existing publicly-traded Delaware firms, (c) subsidiaries of publicly-traded firms organized in other states, or (d) domestic close corporations. But it nonetheless seems highly likely that these large numbers include a cognizable number of out-of-state close corporations.

¹³¹ See, e.g., *Giuricich v. Emtrol Corp.*, 449 A.2d 232 (Del. Supr. 1982); *Oceanic Exploration Co. v. Grynberg*, 428 A.2d 1 (Del. Supr. 1981); *Lehrman v. Cohen*, 43 Del. Ch. 222, 222 A.2d 800 (Del. Ch. 1966); *Ringling Bros.-Barnum & Bailey Combined Shows v. Ringling*, 53 A.2d 441 (Del. Supr. 1947). Interestingly, the Delaware courts have taken a distinct antifiduciary posture in disposing of some issues presented in close corporation cases. See *Nixon v. Blackwell*, 626 A.2d 1366 (Del. Supr. 1993).

sporadic return on the litigation side. But a high-powered incentive may not be needed. One suspects that the requisite investment of time carries a correspondingly low cost, and the returns, although sporadic, would accrue across a long-term.

Turning to the supply side, the class of potential customers for Delaware LLC organization presumably would have attributes parallel to those of its close corporation customers. Several readily suggest themselves. These must be firms as to which transaction cost penny-pinching is not a primary concern, so that the lawyer has discretion to pursue a first-best legal regime. One suspects that such a firm would engage a large law firm. Lawyers at that large law firm might opt for Delaware LLC situs out of dissatisfaction with the local LLC statute.¹³² Alternatively, Delaware organization might be indicated where litigation is foreseeable litigation, as might be the case where parties in interest conduct complex negotiations over conflict of interest points, or where, absent such negotiation, the lawyer nonetheless identifies nascent conflicts. As already noted, the Delaware bar has every incentive to craft an LLC statute that signals sensitivity to the interests such marginal firms.

Having thus hypothesized a national role for Delaware, and hence State 5, in the organization of LLCs, the question arises whether this implies a law development path paralleling that of corporate law, with Delaware taking the role of prime mover respecting LLC statutory and case law. Such a scenario is very unlikely because there is no apparent source of responsive competitive pressure in the other states. Here any litigation business in effect is lost as a result of Delaware's standing reputation as a dispute resolution center, an attraction that cannot be copied, at least at low cost. And, since out-of-state lawyers routinely join Delaware lawyers on Delaware-based litigation, the litigation loss is far from total in the eyes of out-of-state lawyers. Organization business, meanwhile, need not be lost at all so far as they are concerned. One of the factors that has assured Delaware's success as a charter competitor has been its laws' availability to lawyers nationwide — it is the custom for out-of-state corporate lawyers to form Delaware corporations and give Delaware opinions on due incorporation and corporate authority to enter into transactions. The out-of-state organizing lawyer thereby views Delaware as a choice rather than as a threat. For a source of continuing incentives to improve the local LLC statute, we are better off looking to domestic concerns, as the discussion that follows will show.

¹³² A California lawyer has described just such a dissatisfaction to us in conversation.

2. *Incentives for the First Mover State at $t = 0$*

The incentive picture changes only slightly when we change our temporal perspective and survey the five state federation at $t = 0$. Here the question is whether it plausibly can be hypothesized that the first LLC statute will be enacted by a state seeking to take a prime mover advantage and draw on all five states for LLC business. Such a scenario is implausible, at least assuming a modicum of rationality on the part of the each state's actors and an awareness of the history respecting corporate charter competition. Since the other states are free to copy the first mover's statute,¹³³ the time window for a first mover advantage must be short, too short to permit the first mover to develop any less easily replicated expertise that might preserve its leading position over time. First movement with a view to out-of-state business thus is plausible only given a high projected flow of out-of-state fees during the period of time advantage, or given some special (and enduring) advantage on the first mover's part. Significantly, the latter situation of special advantage has figured into the history of charter competition. Delaware's small population enabled its emergence as the chartering jurisdiction: It could credibly commit to serve the needs of large corporations without a risk of local political interference because, given its small size, chartering revenues can make up a substantial portion of its total tax receipts.¹³⁴ Something comparable might be present here if, for example, the interest group alignment in the other four states disfavored LLC legislation. But, as we saw when considering incentives in an island jurisdiction, such an unfavorable political climate cannot plausibly be projected.

But if the first mover does not seek foreign business, how can we account for the appearance of the first LLC statute? If the first mover state is not State 5, then the above description of the incentives of an island jurisdiction provides an answer. *Domestic*, as opposed to foreign demand, plus the local bar's pecuniary interest in satisfying that demand, together completely explain first movement. Foreign demand would figure in only as low probability upside factor — an extra splash of gravy on loaded plate. Such a factor certainly could come into the first mover's cost-benefit analysis. But no implication of determinative influence arises thereby.

Further to this point, consider the possibility that State 5 could take the first mover role as a means to the end of adding litigation business. Given our assumption of certain recognition of foreign LLCs in states without an LLC

¹³³ Ayres, *supra* note 127, at 241-46.

¹³⁴ ROMANO, *GENIUS OF CORPORATE LAW*, *supra* note 86, at 6-12.

statute, that possibility must at least be conceded. But if we relax the assumption and admit a small risk of nonrecognition between $t = 0$ and $t = 1$, the State 5 incentive picture changes radically. Now State 5 lawmakers may project that conservative counsel in States 1 to 4 would advise that any State 5 organization be in the corporate form pending termination of the risk of nonrecognition by means of domestic enactment of LLC legislation. They furthermore might ask themselves whether State 5's interests are served at all by first movement respecting a novel business form. That very novelty, coupled with the prospect of easy replication by the legislatures of other states, creates a risk of dissipation of the value of its accumulated experience and consequent business loss. On this scenario, then, State 5 is the least likely first mover due to the combination of a vested interest in the status quo and a low level of domestic demand.

3. *Incentives to Copy Between $t = 0$ and $t = 1$*

The same domestic demand factors that best account for the actions of the prime mover also come to bear in explaining the actions of the other states during the period of proliferation of LLC statutes. One can plausibly model the statutes' rapid diffusion as a sequence of domestic events, without any reference to interstate competition. Simply, the organized bar of each state invests in securing the legislation in pursuit of domestic revenues. Note that nothing in this description denies the appropriateness of the law as product analogy. Law is as much product here as it is in the charter competition model. Here, however, cost advantages enjoyed by the local producer make it a *domestic* product.

But, given enactment by the first mover, might not competition figure into the legislation's proliferation because bar associations of the follower states either experience loss of business to the prime mover or fear a potential loss of business? The first of these two suggestions presupposes first, no relaxation of our assumption of certain recognition of foreign LLCs, and, second, a somewhat stylized model of interest group activity. Recall the sensitive cost-benefit profile of the bar's small business customers. Given this sensitivity, any firms unlikely to be deterred by the additional costs of out-of-state-organization presumably already will be organized domestically as Subchapter S corporations.¹³⁵ Accordingly, no massive, statewide loss of business plausibly can be projected. A limited loss of business at the state's borders is a more

¹³⁵ Out-of-state reorganization as an LLC is possible for such a firm, but such a step would seem unlikely given any uncertainty as to domestic recognition.

likely possibility.¹³⁶ But such a projection literally depends on the customer firm's geographical proximity to the border — the proximity minimizes the firm's information costs and other transaction costs. For this competitive causation story to work, information about such border-town lost business must then diffuse to and motivate the actors in the state bar who procure the legislation.¹³⁷ Such a scenario is not implausible, although it works best where the border-town is itself a place of influence in the state.¹³⁸

The story's plausibility does not, taken alone, propel it to the top of the list of likely causative factors in the proliferation of LLCs. After all, the very fact of loss of business to a neighbor reinforces a projection of untapped domestic demand. In addition, the overall risk of business loss to the bar declines sharply once State 5 enacts an LLC statute. Recall that State 5 stands in here for Delaware and that it is the custom for out-of-state corporate lawyers to form Delaware corporations and give Delaware opinions with the Delaware bar taking its special rents from litigating. Thus, once State 5 has an LLC statute, a lawyer in a State 2, still lacking an LLC statute, plausibly can compete with a cross-border lawyer in State 1 by offering organization in State 5 to a firm client desiring LLC status. Of course, State 5 organization being more costly than domestic organization, the State 5 alternative provides no basis for the realization of maximal LLC fee revenues by the State 2 bar. On this scenario, then, local lawyers never need lose business to out-of-state lawyers. But they nevertheless retain a powerful incentive to secure the enactment of domestic legislation. Finally, we note a close and enervating tie between this scenario and the assumption of certain foreign LLC recognition in non-LLC states. If we relax the assumption and introduce uncertainty respecting recognition of a State 5 LLC in State 2, then, at least until $t = 1$, the State 5 solution is doubly suboptimal for both the State 2 lawyer and the client. The implication of domestic causation in State 2 is proportionately strengthened.

¹³⁶ See *Ribstein IV*, *supra* note 96, at 400 (hypothesizing that Kansas City, Missouri, lawyers might lose LLC business to lawyers in Kansas City, Kansas); Ayres, *supra* note 127, at 375 (suggesting that Delaware might take close corporation business from Pennsylvania).

¹³⁷ David Rice, *Product Quality Laws and the Economics of Federalism*, 65 B.U.L.REV. 1, 52-60 (1985), articulates such a scenario in the context of product safety standards.

¹³⁸ Thus does Ribstein place Kansas City in the story. Carney, *supra* note 99, at 859, suggests that the cross border business loss might be an influential fact even absent a business center with a border location. He recalls a mention in a Georgia bar association committee of south Georgia businesses crossing to Florida to organize as LLCs, and speculates that similar stories were told nationwide during the period of LLC proliferation.

But this lost business story can be restated so that it survives despite the foregoing analysis. We simply say that risk averse State 2 lawyers fear lost business, even though on reflection they will see that no significant amount of business actually need be lost. This less pointed version of the story is notably easy to tell. So long as even one firm might find it cost beneficial to organize out of state and accept the risk of nonrecognition, it will be plausible to say that the actors moving the bar association 'fear' a loss of the business. At this level of generality, a regulatory competition story can indeed be included in the description of the proliferation of LLC statutes.

The high level of generality denudes the story of most of its descriptive authority, however. Loss of business to another state is a constant possibility respecting business organizations in a federal system that does not follow a rule of *siège réel*. In such a system, the presence of out-of-state alternatives acts as an intrinsic limit on the zone of any given state's lawmaking discretion respecting business associations. No state enjoys a natural monopoly.¹³⁹ Furthermore, in the long run, a state refusing to follow the LLC trend hobbles its small firms with an extra level of costs, and, given the long-term possibility of relocation of assets, may even experience a loss of economic activity. But the fact of the projection and the presence of out-of-state alternatives do not by themselves dictate the conclusion that a particular body of law results from the competitive disposition of the state's legislature. In a world of interest group politics, competitive incentives on lawmakers' parts cannot be assumed. In order credibly to draw on the background constant of interstate movement of individuals and production factors in ascribing a competitive origin to particular legislation, therefore, incentives must be described with particularity. In the case of LLCs such a competitive description can be made with complete plausibility on a domestic basis. The regulatory competition overlay amounts to surplusage.

E. Summary — LLCs, Regulatory Competition and Evolutionary Efficiency

We conclude that regulatory competition can be accorded no more than a secondary place in a plausible account of the proliferation of LLC statutes. We can account completely for the fact of enactment by reference to the financial incentives of the pertinent domestic interest group, the bar. Between $t = 0$ and $t = 1$, the second level causal contribution of regulatory competition at most

¹³⁹ *Ribstein IV*, *supra* note 96, at 400. As Ribstein points out, no state has the discretion to raise its franchise taxes above a minimal, competitively set level. *Id.* at 399.

concerns not to the fact of adoption but the timing of adoption. Here the particular point to be explained is the unusually rapid action taken by bars and legislatures. As to this phenomenon, local scare stories about business lost to lawyers in other states fits neatly into a plausible causation story. But, remembering that money has a time value and that local lawyers have fixed costs of operation to cover, local financial incentives also must figure importantly in the explanation of the velocity of enactment. After $t = 1$, certainty of foreign recognition triggers the special incentives of the bar of State 5 so that a competitive posture respecting LLC legislation becomes an active possibility. But no federation-wide implication of competitive responsiveness thereby arises.

This account must be sharply distinguished from competing descriptions of the LLC phenomenon that accord regulatory competition and interest group politics co-equal status.¹⁴⁰ Those descriptions tend to be used to support of bottom-line efficiency assertions,¹⁴¹ for in theory regulatory competition serves as a means to efficient ends. Unfortunately, however, a pre-existing need to add support to a problematic efficiency assertion imports no plausibility to a descriptive finding, whether of regulatory competition or anything else.

Even if there were some specific empirical evidence or a structural factor that justified according regulatory competition a coequal place in the description of the proliferation of LLCs, support for an efficiency assertion would not necessarily follow. Regulatory competition has a very precise efficiency function: It promotes efficiency by causing citizen preferences to be matched with legislative outcomes, and as a result is held out as a cure to the problem of legislative capture described in public choice theory. Thus does the efficiency case for the LLC run into a problem, since interest group influence figures prominently in all accounts of the proliferation of LLC statutes. As a result, the exercise of admitting regulatory competition to a coequal place in the description literally says that competition here serves the perverse function of hastening the rate of adoption of a piece of interest group legislation! If we in addition make the above assumption that LLC legislation effects an inefficient balance between loss externalization and transaction cost reduction for small businesses, the inclusion of actual or potential regulatory competition in the description implies a possible lock-in of the inefficient result.¹⁴² To

¹⁴⁰ See *Ribstein IV*, *supra* note 96, at 397 (asserting that LLCs 'emerge from a combination of political forces and jurisdictional competition'); Macey, *supra* note 13, at 446-47 (arguing that the states compete for chartering revenues respecting LLCs).

¹⁴¹ *Ribstein IV*, *supra* note 96, at 412; Macey, *supra* note 13, at 442-43, 446-47.

¹⁴² We have made a parallel argument respecting public corporations. See Bratton and

see this possibility, hypothesize that groups detrimented by the adoption of an LLC statute organize politically in a single state to attempt to bring about a roll back. Surely in the resulting political contest the benefitted groups, lawyers and small business, would plausibly counter that a single state cannot effectively take a unilateral position against the trend in a competitive federal system.

Regulatory competition also has a second efficiency function: It promotes efficiency by providing an incentive for innovation by junior level governments. The LLC story strongly implies the presence of such an incentive to innovate. First, the states have enacted these new statutes in a short period of time, and, second, the terms of the statutes they enact (or amend) have changed during that short period of time so as to favor enhanced flexibility.¹⁴³ But can we take the existence of innovation, by itself, as sufficient proof of efficient results? No, for given a strong rent-seeking incentive on the part of a dominant interest group, a burst of regulatory (or deregulatory) innovation may signal a deadweight loss to society. Can we furthermore take the existence of innovation, by itself, as sufficient proof of the presence of interstate competition? No, for innovation may be prompted by domestic as well as interstate competitive incentives. With LLCs, domestic rewards by themselves suffice to explain the close attention paid by state lawmakers (and bar associations) to the terms of LLC statutes. The lawyers seek a statute that provides maximum access to the group of firms that otherwise would go into or remain in business in the partnership form. Some trial and error in the achievement of that end is only to be expected. Meanwhile, given that we are talking about small business, it simply does not seem plausible to suggest that nuances in the terms of LLC statutes cause a significant amount of LLC business to flow across state lines. Although the possible appearance of a Delaware LLC 'boutique' directed to a small class of firms does, literally, modify the description, it has no bearing on the description's policy implications.

McCahery, *supra* note 94, at 1885-90.

¹⁴³ Ribstein IV, *supra* note 96, at 412-28.

F. Regulatory Competition and Producer Incentives

The foregoing discussion follows from the view that regulatory competition stories cannot be told on a black box basis that avoids inquiry into the incentives of government actors. With regulation, self-interested production does not necessarily imply product entrepreneurship. Governments, unlike firms, do not labor under an immediate threat that bankruptcy results from suboptimal decisionmaking. As a result, agency problems in the production of public goods tend to be more substantial than those within firms.

Certainly, government actors sometimes do act entrepreneurially. Presumably, this occurs when the tax revenues, export earnings, jobs, technology, or other positive externalities yielded by the attraction of factors of production also happen to yield appropriate political benefits, either in the form of electoral advantage, satisfaction of the demands of favored interest groups, or the satisfaction incident to enhancing public welfare.¹⁴⁴ It is less certain that this incentive relationship can be assumed as a systematic proposition. Indeed, where it does exist it can be ephemeral. Unlike firms, which must hew to the profit incentive over time, the objectives of government suppliers change over time with voter preferences.

The exercise of opening up regulatory competition's black box and inquiring as to competitive incentives shows that special conditions tend to obtain in those cases in which government entrepreneurship becomes wrought into a lawmaking structure. Consider corporate charter competition in this regard. There we do see recognizable buyer-seller relationships, but it also turns out that in practice competitive charter provision is not a game that every state can play. Significant competitive incentives do not show up across the class of potential suppliers. Small jurisdictions tend to take leading competitive roles: Delaware is the jurisdiction of incorporation of about half of the corporations listed on the New York Stock Exchange. Similar conditions obtain in parallel cases of sale of juridical status — small island states tend to offer themselves as tax havens; Liberia, Panama, and Greece lead in the registration of ships. The explanation prevailing for Delaware probably applies across the board. Corporate franchise fees amount to 15 percent of Delaware's tax base; the same cash flow would be a trivial percentage of the tax base of a large state. Given a limited market, competitive success has a larger percentage impact on the smaller government budget of a small jurisdiction. Political and financial

¹⁴⁴ Or, in the alternative, the particular factor cuts an advantageous deal with the responsible government actors directly.

incentives to create (or enter) a legal product market arise when such a significant payoff is held out. The incentive relationship lends plausibility in the product market in turn. The small jurisdiction's propensity to fiscal dependence on its legal business provides a structural assurance that customer interests will take precedence over all competing interests in local political deliberations.¹⁴⁵

Even where incentives to compete clearly are present, additional incentive problems may inhibit the evolution of first-best legal products. Network externality models,¹⁴⁶ for example, show that a demand-side problem can cause suboptimal equilibria to evolve and product innovation to be choked off in situations of intense product competition. Supply-side problems also may come up. Product innovation presupposes an incentive to invest in research and development. With industrial competitors, prospects of a patent monopoly bolster the incentive. The patent deters entry by competitors, assuring a potential return on investment in research and development.¹⁴⁷ Conversely, if an innovation easily can be copied by a rival, then new technologies will not efficiently replace old technologies. Legal innovation leads to the production of a public good, and carries no patent protection. Ian Ayres, applying this point to corporate law, suggests that competing states will have insufficient incentives to invest the resources in product innovation.¹⁴⁸ State legislatures

¹⁴⁵ ROMANO, *GENIUS OF CORPORATE LAW*, *supra* note 86, at 6-12. But even given such a clear-cut incentive in favor the interests of a given customer, integration with the rest of the federal system can create complications. For instance, where enforcement is through private lawsuits, states do not fully control their product because parties are free to sue elsewhere. *See* Hay, *supra* note 112, at 652. In the corporate law context, this incident of federalism has complicated Delaware's incentive picture. It must offer the plaintiff's bar sufficient returns to induce litigation in the state while simultaneously maintaining a reputation for privileging the interests of management. *See* Bratton and McCahery, *supra* note 94, at 1898-1900.

¹⁴⁶ For a survey of the literature, *see* Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757 (1995).

¹⁴⁷ The basic patent model assumes that there is an optimal way to stimulate firms to invest in research and development, which is deemed to be necessary for product innovation. The patent prevents a rival from introducing a sufficiently close product, and thus makes the rival's entrance into the market more costly. The patent will completely deter such entrance under certain assumptions — for example, in a homogenous-goods industry in which the monopolist is the only firm able to outbid the entrant to acquire the innovation. *See* John Vickers, *Concepts of Competition*, 47 OXFORD ECON. PAPERS 1 (1995); R. Gilbert and D. Newberry, *Preemptive Patenting and the Persistence of Monopoly*, 74 AMER. ECON. REV. 238 (1982). But patentability does not by itself foreclose entrance into the product area.

¹⁴⁸ Ayres, *supra* note 127, at 241-46.

will see no point in entering a race to innovate if any resulting lead will be exhausted in a very short period of time. Under this approach, the efficient rate of legal innovation will depend on the probability of a state having the optimal degree of patent protection.¹⁴⁹ If the response to this suggestion is that legal innovations intrinsically belong in the public domain, then law turns out to be quite different from product.

III. CONCLUSION

Domestic incentives, taken alone, support a presumption that the LLC is evolving so as to provide a cost-effective limited liability shell for small firms. Any further conclusion respecting the development's overall efficiency obviously depends on an absent factor — a clear cut basis for assuming that limited liability itself is efficient.

¹⁴⁹ Ayres also suggests that an especially fast race between states will result in rent dissipation. *Id.* at 246-51. In this leader-follower model of entry deterrence, if only the leader state adopts the new technology, it receives all the profits from the innovation. But the rents decrease if imitators can free ride. The larger the spillover to competitors, the larger the incentive problem. JEAN TIROLE, *THE THEORY OF INDUSTRIAL ORGANIZATION* 400 (1988).

CHAPTER 7

LAWYERS AND LAWYERING, FROM STRUCTURE TO PROCESS¹

7.1 Introduction

The recent spate of work on the practice of business lawyering has begun belatedly to make up for the surprising neglect of the topic by sociologists of law, or social theorists generally. An important reason for the neglect of the consideration of lawyering as a process has been the predominance of structuralist perspectives in the sociological study of the legal profession. Furthermore, both theoretical perspectives and practical factors have led those sociologists who have attempted to analyse lawyer-client relations to concentrate on encounters with individual clients rather than the work of lawyers for business. The image of the lawyer as dealing essentially with the private problems of individual clients has become harder to maintain with the increased prominence, first in the US and then in many other countries, of the large, bureaucratized law firm specializing in commercial and business law (Galanter 1983; Galanter and Palay 1991), and the sharpening of the division between lawyers who serve corporate clients and those with a practice predominantly of individuals (Heinz and Laumann 1982).

7.2 Theories of the Professions

The predominance of structuralism is noticeable, despite the continual flux of theoretical perspectives in this field over the past twenty years. The focus of sociologists, stemming from the study of the social role of professions and professionalism generally, has been on the control of specialized expertise. Initially the dominant viewpoint was functionalist, assuming the utility of specialized knowledge and of the 'bargain' by which society was said to grant

¹ This chapter appeared (with Sol Picciotto) in Y. Dezalay and D. Sugarman (eds.) *Professional Competition and Professional Power* (London: Routledge 1995).

professional groups self-regulatory autonomy. From the 1970s this came to be criticized as ignoring questions of power and the role of the state (Larson 1977; P. Lewis, in Abel and Lewis 1989; Rueschemeyer 1983). Professionals such as lawyers were seen as trying to achieve status, prestige or power, on the basis of claims to specialized knowledge resulting from the mobilization of resources. A more complex picture was then further developed, which included the importance of other factors such as access to state power, and the need to consider the historically specific conditions of development of particular societies (Luckham 1981). However, studies in the field became dominated by discussion of the thesis originated by Magali Larson and most forcefully put forward by Richard Abel which, in brief, argued that the legal profession has generally aimed to secure monopolistic markets for its specialized services by controlling the production both of and by the producers, or by seeking to create demand for these services (Abel, in Abel and Lewis 1989: vol. 3, ch. 3). This argument was in turn criticized by studies showing that professionals often have little control over their markets or their clients (e.g. Paterson, in Abel 1989: vol. 1). While undoubtedly the profession tries to establish and maintain market control, such measures are often reactive, and it is not clear that market control is the source of the power or privilege of lawyers.

What is clear is that most of these discussions have tended to leave out any examination of the nature and process of lawyering itself.² This lack was stressed in relation to the study of professions more generally by an important new work by Andrew Abbott, who pointed out that existing studies had talked 'less about what professions do than about how they are organized to do it' (Abbott 1988:1). For Abbott, the main difficulty with the prior concept of professionalization was its 'focus on structure rather than work' (ibid: 19). He defines professions loosely as 'exclusive occupational groups applying somewhat abstract knowledge to particular cases' (p. 8), and emphasizes that it is the control of the abstractions which generate the practical techniques that distinguishes professions from other occupational groups such as crafts, since 'only a knowledge system governed by abstractions can redefine its problems and tasks, defend them from interlopers, and seize new problems' (p. 9). Abbott provides an interesting analysis of professional work, organized around 'the sequence of diagnosis, inference, and treatment [which] embodies the essential cultural logic of professional practice' (p. 40); and he explores the relationship between professional practice and the academic knowledge which

² This was belatedly recognized by the inclusion in the massive three-volume comparative study edited by Abel and Lewis of a final chapter called '*Bringing the Law Back In*', which sketched some considerations for the study of lawyers work. However, this project did not include any actual studies or analyses of lawyering.

formalizes these skills and gives professionals cultural legitimacy by the essentially symbolic power with which it links those professional skills to major cultural values, usually of rationality, logic and science (pp. 52-4). By starting from the characteristics of professional work, Abbott's approach redirects attention from the structural concerns of organization to the interaction between the competitive system of professions and their environment. However, he himself perhaps over-emphasizes the structural character of the 'system of professions', which he sees as essentially reacting to external forces which cause a competitive struggle over the reshaping of professional tasks (ibid.:33), leaving little space for the dynamic role of professionals in helping to construct the social world.

7.3 Studies of Lawyering

Despite the limitations of the general theories of professionalization, a handful of pioneering sociological studies have been made of the actual process of lawyering. In addition, others have put forward various analyses of the process, calling upon diverse types of evidence,³ including contemporary accounts both of the major exploits of big business lawyers and direct experience of its more routine aspects, as well as historians' reports of the role of lawyers in the creation of corporate capitalism based on studies of the archives of major law firms and memoirs of leading practitioners.

The issue that is posed by shifting the concern from structure to process is the nature of the 'transformation' that takes place in lawyer-client interaction (Felstiner et al 1980-1). Studies of lawyering generally agree that the lawyer's task is to convert the requirements of the client into legal solutions, and

³ The confidentiality of lawyer-client relations has been a serious barrier to access for a researcher; since an observation study requires initial cooperation from the lawyer and then permission from each client, entailing practical problems which may prevent a study taking place (Danet 1979-90) as well as meaning that the interviews observed are likely to be a highly selective sample. Nevertheless, some observation studies have been carried out (Cain 1979; Sarat and Felstiner 1986). Research based on participant-observation has focused less on the process of lawyer-client interactions and more generally on lawyers strategies (Mann, 1985; Flood 1991). An interesting study by K. Mann concerned a relatively small group of white-collar criminal defence attorneys in the Southern district of New York, and began with in-depth, open-ended interviews, but was supplemented by participant observation, the researcher taking employment as an associate with one of the lawyers being studied (Mann 1985). Others have used their personal experience of law practice, focusing on a specific type of transaction for which documentation is available, e.g. Gilson's (1984) analysis of the role of lawyers in mergers and acquisitions focusing on the drafting of a corporate acquisition agreement.

emphasize that this is by no means limited to litigation or dispute-settlement. But once the lawyer is recognized as 'gatekeeper to legal institutions and facilitator of a wide range of personal and economic transactions' (ibid.: 645), many issues arise as to the nature of the conversion or transformation that takes place between the client's concerns and the lawyer's solutions.

Some studies still see the lawyer-client relationship simply as a structured power relation, in which the extent to which the client can obtain the lawyer's specialized knowledge or skills depends on the client's wealth and other related factors, such as the likelihood of repeat business or other connections through this client, perhaps weighed against the lawyer's loyalties and ties to other actors (other clients, the opposing lawyer, and so on). In this perspective, the lawyer as 'gatekeeper' to the legal realm is motivated mainly by financial reasons, but also social and cultural ties such as loyalty, in deciding whether and with what degree of assiduity to venture on behalf of the client into that realm to bring back the desired legal outcomes. Thus, Abraham Blumberg argued that important procedural rules laid down by courts as a protection for criminal defendants are in practice rendered nugatory because defence lawyers do not act as adversarial representatives on behalf of (mainly indigent) clients, but are 'bound in an organized system of complicity in which covert, informal breaches and evasions of due process are institutionalized, but denied to exist' (Blumberg 1966-7: 22); the strong ties of criminal defence lawyers to court personnel and their involvement in the unwritten rules and routines of the system mean that what they do is not really private practice but bureaucratic practice (ibid.: 31). Similarly, Stewart Macaulay argued that consumer protective lawyering and business regulation protection legislation was ineffective, because he found that lawyers were generally reluctant to utilize legal provisions and procedures in a serious way, preferring conciliatory negotiation, since they regard consumer cases as unimportant as well as unlikely to generate lucrative repeat business (Macaulay 1979). Although these studies focused on the characteristics of lawyering in practice, they adopted a rather simple model of lawyer-client interaction, and reinforced the view of the lawyer as possessor of privileged knowledge.

A radically new approach was put forward by Maureen Cain, who rejected the perspective of social control by the lawyer of the client based on their positions in the social structure, emphasizing instead the need to study lawyering as a specific practice, centring on lawyers' role as 'conceptive ideologists, who think, and therefore constitute the form of, the emergent relations of capitalist society' (Cain 1979: 335). This was based on two central points. First, that lawyers act typically as agents for the bourgeoisie (in its various forms), and far from controlling their clients, they are often highly dependent on them, or at least must compete to offer services for which clients are willing to pay. Second, Cain focused on the specific practice of lawyering

as translation:

Clients bring many issues to the solicitor, expressed and constituted in terms of a variety of everyday discourses. The lawyer translates these, and reconstitutes the issues in terms of a legal discourse which has transsituational applicability. In this sense law is a meta-language. Its material significance, however, derives from the fact that it is also the workaday language for certain state authorized adjudicators.

The combination of these two points provided an important new perspective, supported by the detailed accounts resulting from her pilot observational study.⁴ Cain's argument integrates some elements emphasized in previous studies to help explain the relative dependencies in the lawyer-client relation, such as whether a client represents an important source of repeat business. However, an important new dimension was introduced by refocusing on the specific practice of lawyering as an ideological mediation and translation between the needs of the client, expressed in everyday discourse, and the specialized discourse of the law, which the lawyer also helps to create.

This perspective introduces a more differentiated approach to the analysis of lawyer-client interaction. First, it recognizes that the conversion of the client's problem into legal terminology and the search for a legal solution which can be reconverted into an acceptable one in the client's world, is a common concern of both parties. Although the lawyer's professional expertise may entail some socio-psychological advantages in the immediate relationship (some lawyers may be able to browbeat some clients), this is not structurally determinative, for the lawyer must compete with others in the provision of this service. The question is, rather, the nature of the interaction between the realm of the law and that of 'everyday' social relations in which it is primarily the client who initially defines the problem.

Certainly, this entails a 'legal construction of the client', and the lawyer may take the lead in 'educating' the client as to the law's requirements. Sarat and Felstiner have provided a detailed micro-study illustrating how a client conference involves the 'construction of a legal picture of the client, a picture through which a self acceptable to the legal process is negotiated and validated' (Sarat and Felstiner 1986:116). They provide a valuable account of the way legal professionals behave as if it were natural to separate out those aspects of human behaviour with which the law is willing to deal, thus implicitly legitimating parts of human experience and contributing to the 'reification' characteristic of law (Gabel 1978). However, this begs the question of

⁴ Regrettably, the importance of this study was not recognized, and funding for a full-length study was not forthcoming.

legitimation of the law itself.⁵ If the client has a ready made, practical, socially functioning self, whence comes the need for its legal reconstruction? If this need is considered to be externally imposed, as part of a social power-structure involving the state, how is it validated or legitimated, if it involves distortion of a previously whole 'self'?

It seems necessary to accept that the client's social self is constructed by intersecting social processes, of which legal discourse is one. After all, if a person has become a client it is by some sort of prior recognition that there is a legal dimension to the social circumstances in which the problem arises to which a solution is sought. Further, and this involves the second important aspect of Cain's argument, the lawyer carries out not only the translation of the client's problem into legal terms, but also (once a legal solution has been found) a retranslation back into the client's everyday discourse. Hence, the solution found in the legal realm must in turn be validated by successful interaction with the other social processes contributing to the social construction or reproduction of the client's self.

7.4 Business Lawyering

This point is more clearly brought out through consideration of business lawyering, for several reasons. First, it focuses on the client as an organization rather than an individual, thus de-emphasizing the socio-psychological aspects of lawyer-client interaction. This brings more sharply into focus the point that both the skill of the lawyer, and the legitimation of the legal process generally, depend on the extent to which they make an effective contribution to the ensemble of processes interacting on the business enterprise. This has been very effectively analysed from an economic perspective, in particular by Ronald Gilson (1984). From this point of view, it is clear that business enterprises will not resort to lawyers, nor request them to seek legal solutions, unless lawyering 'adds value' to the business transaction in question. Gilson shows in detail, through an analysis of the drafting of the complex acquisition

⁵ Robert Gordon, in his important essay on the effects of the turn to corporate law practice on New York lawyers after 1870 argues that law itself entails a legitimizing ideology, by offering 'an artificial utopia of social harmony (Gordon 1984: 53); he argues that this universal vision was embodied in an ideal of law practice, rooted in liberal individualism, which was undermined by the fragmentation of that order, a process to which lawyers contributed considerably, especially through their service of corporate power. This created a disjuncture between the old ideal of the law and the practical tasks lawyers were called upon to perform on behalf of clients, which was only partly remedied by the attempt to reconstitute a new progressive vision of the corporate lawyer, since the new synthesis was too liberal-reformist to be acceptable to clients and the courts.

agreements common in (US) corporate mergers and acquisitions (M&A) practice, that the lawyer acts as a 'transaction cost engineer', assisting the parties in pricing the transaction at the lowest cost. In other words, from the internal perspective of economics, the lawyer adds value to the transaction as a whole if transaction costs can be reduced or eliminated, for example by maximizing the availability of relevant information to parties and guaranteeing its veracity, to assist the establishment of homogeneous expectations and thus a successful economic exchange. However, other professions (notably accountants and investment bankers) also perform broadly similar functions, so an economic analysis cannot explain the existence of a specifically legal function, although it may provide criteria for testing its efficiency. Interestingly, Gilson is driven to accept that the existence of such a specifically legal function in economic transacting cannot be shown by economic analysis, but depends on the existence and character of state regulation of such transactions (ibid: 296-8).

Gilson characterizes the role of 'transaction cost engineer' as not a specifically or traditionally legal one, even when it entails the drafting of immensely lengthy and complex contracts, since 'when lawyers play this role well, the courts and formal law generally, shrink dramatically in importance' (p. 294). However, one of the important points which results from the study of lawyering is that lawyers in practice engage in a wide variety of activities broadly concerned with the facilitation of transactions, and are not exclusively or even primarily concerned with litigation. In the UK for example, the bedrock of the market for solicitors' services, even for individual clients, has long been, and despite many changes still remains, house conveyancing and wills-and-probate; even the Bar, which defends its monopoly of rights of audience in the higher courts, relies for most of its work on drafting documents and opinions. Disputes and litigation are in any case better understood as the pathology of a regulatory system. This makes it all the more important to try to develop an analysis to help us understand whether there is any specifically or inherently legal function in facilitating economic and social transactions.

Hence, it is necessary to consider the characteristics of the private ordering which lawyers carry out for clients, and its relationship both to formal law and to the economic or social aspects of the client's transactions. Returning to Gilson's analysis of a corporate acquisition agreement, it seems clear that the need for a lengthy contract embodying a very detailed specification of the business being acquired results from low-trust factors in the relationship of the transacting parties: a corporate acquisition is usually a one-shot operation, and the potential gains from opportunism or cheating outweigh any long-term disadvantages, hence the need to juridify the relationships.⁶ Of course, in a

⁶ Gilson additionally points out that the major law and accountancy firms involved also

different social setting there might be far less need for detailed contracting. Indeed, the increased research into business lawyering in the US results partly from concern about the loss of competitiveness of US business, especially in relation to Japan, and the accusation that the US system over-invests in non-productive professional activity (particularly lawyering) while Japan concentrates on professions such as engineering, which make a positive contribution to production.⁷ Hence, it is said, not only does Japan have many fewer lawyers, but a typical business contract will not be thick and detailed, but rely essentially on a general good faith provision leaving any disagreements which may subsequently arise to be worked out by the parties.⁸ This comparison raises manifold considerations: perhaps Japan is a more homogeneous society where even business relations are less prone to opportunism; or perhaps the opportunism is constrained by other factors, notably a more stable (or even rigid) managerial system together with other factors (such as the role of the *zaibatsu* and *keiretsu*) which cement longer-term relationships between firms and the senior managers representing them, but which may also carry their own costs such as loss of entrepreneurial spirit (Gilson 1984: 307-12).

However, our concern in this chapter is rather with the relationship of business lawyering to the forms and institutions of formal law. In particular, we want to explore the interaction between lawyering and the development of the regulatory forms in and through which corporate capitalism develops. This entails consideration of the extent to and ways in which lawyers themselves contribute to the creation and development of the legal forms regulating business.

7.5 The Indeterminacy of Legal Rules and Lawyering as a Social Practise

The lawyer's specialized knowledge is of the more or less abstract and formalized rules which are the object and product of legal discourse; and it is the practising lawyer who acts as the mediator between this field of formal rules and the arena of economic and social relations inhabited by the client. The characterization of the legal sphere or field and of its relation to economic relations and social life more generally is a central concern of social theories

act as reputational intermediaries since, unlike the primary parties, they will expect future mutual dealings.

⁷ This was forcefully expressed in the Report of Derek Bok (himself formerly a business law teacher) as President to the Board of Harvard University, cited both in Gilson (1984) and by several of the contributors to the symposium on corporate law firms published in *Stanford Law Review*, 34 (1984).

⁸ Gilson 1984: 308, citing Akio Morita, former chairman of Sony.

of law. In this section we consider in what ways the study of lawyering as a social process can illuminate this central question.

We focus on the characterizations of legal rules as unclear or indeterminate, and the role of lawyering in relation to that indeterminacy. One result of the increasing global competition in the field of professional legal services is a concern that lawyers may excessively exploit the loopholes and ambiguities of the law on behalf of clients, and that as a result 'creative compliance' with regulatory requirements may undermine the efficacy of regulation. This has been the subject of academic analysis (e.g. McBarnet 1988; McBarnet and Whelan 1991; Power 1993), as well as broader political concern. Thus, in 1992 the Legal Risk Review Committee set up by the Bank of England proposed a number of measures to deal with difficulties that may be caused for London's financial markets by legal uncertainty. This was due to concern caused by the losses to financial institutions following appeal court decisions holding that local authorities were acting outside their powers in engaging in 'swap' transactions; although the Committee identified other problems of uncertainty in the regulation of dynamic and constantly changing markets (Bank of England 1992a; 1992b). More broadly, however, there is concern that the globalization of financial markets means that traditional practices based on understandings among closed City networks are inevitably being replaced by a more juridified approach, and City of London regulators have shown themselves to be, at the least, unaccustomed to dealing with this environment, as evidenced by a string of 'regulatory failures', such as the Guinness, BCCI, and Maxwell affairs.

However, the question of 'compliance' with rules and 'creativity' in relation to them involves some fundamental philosophical concerns. Thus, we must first consider the various ways in which this indeterminacy has been characterized in jurisprudence and in social theories of law.

7.6 The Indeterminacy Critique

While there is considerable debate and controversy regarding the indeterminacy thesis, even some positivist theories accept that rules are not altogether certain. Indeed, it is central in the work of H. L. A. Hart that rules have a core and a penumbra.⁹ However, for Hart this indeterminacy is

⁹ In his exchange with Fuller, Hart argue that words have a settled core meaning, but that in cases where there is no core meaning the law is 'incurably incomplete' and interpreters by discretion decide penumbral cases. Thus, he states, 'If a penumbra of uncertainty must surround all legal rules, then their application to specific cases in the penumbra cannot be a matter of logical deduction, and so deductive reasoning, which for generations has been cherished as the perfection of human reasoning, cannot serve as a model for what judges,

merely linguistic: his theory is based on a distinction between the core and penumbra meaning of words. There is a settled area, the core, in which the meaning of words (and therefore of rules) is uncontroversial, and a realm of uncertainty which is characterized as penumbra where there can be disagreement due to the vagueness of terms and the open-textured quality of language. In Hart's view, these disagreements can be resolved by reference to the settled core of meaning which limits the boundaries of all disputes over the meaning of a word or term.

The issue of the indeterminacy of law has been put most strongly by critical (CLS) and post-modernist legal scholars, although the origins of this perspective lie in Realist legal theory.¹⁰ These theorists argue that legal doctrine is internally contradictory, and as a result the legitimacy of legal decisions is suspect and the rule of law undermined. The antinomies, inconsistencies or contradictions of legal doctrine and legal reasoning mean, for some, that judges, by engaging in legislative decision-making, impermissibly usurp the role of the legislature and the efficacy of consent.¹¹ For the most part, critical legal theorists, in their analysis of the indeterminacy of legal doctrine, attempt to demonstrate that the law is incoherent and contradictory and that there is no meta-principle or norm which is capable of reconstructing the unstable and highly contingent 'patchwork quilt' that comprises legal doctrine (Altman 1986; for a critique of Altman, see Balkin 1991: 1145-53). As a result, liberal law is contradictory and there are no foundations for legal determinacy.

Thus, for CLS scholars, the indeterminacy critique is central to their attack on liberal legalism and formalism. Formalism is based on the idea that law is a closed system which contains all the resources necessary to justify its

or indeed anyone, should do' (Hart 1958: 607-8). Thus, Hart's argument was that borderlines must be drawn, whereas Fuller argued that meaning is always tightly connected to the aim of the legal rule. Recently, Dennis Patterson has tried to reconcile the Hart-Fuller divide, arguing that while Hart is correct to draw hard lines in the law, Fuller is also correct in claiming that the line should be drawn based on the 'settled context of use.' Hence, for Patterson, what counts is the formal element of the rule which makes the rule intelligible to an interpreter (Patterson 1990: 961-3). However, Patterson's perspective remains within linguistic philosophy, although emphasizing a Wittgensteinian view of context.

¹⁰ The Realists attempted to show that formalism is an impossible project. For the most part, the Realists claimed that law is deeply subjective and contradictory and therefore a purely formal system is implausible to justify since it is rooted in the values and assumptions which it purports to exclude, viz., politics, morality, etc. Several authors have pointed to the continuities between the Realists and CLS: see e.g. Brigham and Harrington 1989.

¹¹ Ken Kress (1989) examines the work of Altman, Singer and Kennedy, to show that, like liberals, CLS theorists think that legal determinacy is necessary to ground consent: Kress argues there are other grounds to uphold just institutions.

actions.¹² It is predicated on the claim that there is an internal principle of unity that structures and controls the legal system; thus, Kelsen (1967: 299) considers that the law regulates its own creation. Formalism has tended to support law's claims to objectivity, neutrality and consistency, because it implies that the mechanical application of legal rules provides a basis for constraining interpreters and justifying the values purportedly embodied in the rules. The radical critique aimed, by exposing the indeterminacy of rules, to show that the process of adjudication reflects and embodies deeper differences at the level of society. Thus, Duncan Kennedy, in his celebrated analysis of the difference between rules and standards in the context of contract and tort law, aimed to deconstruct the form of law and to show that rules tend to serve individualism while standards are consistent with altruist viewpoints (Kennedy, 1976).

By showing the struggle between two competing and opposed conceptions of doctrine, Kennedy attempted to show that there are both individualist and altruist arguments that might be employed by a judge in every legal decision. Thus, for him, adjudication involves a choice between two competing political visions: self-reliance, as reflected in rule-like forms, and altruism, reflected in the resort to standard-like forms.¹³ The implication of Kennedy's analysis is that deep structures of cultural meaning ensure that individualist or altruist arguments will support their respective positions. Hence, his argument appears to depend on the view that there is a deep system of structures, in which the elements are defined in terms of difference, and that each vision is dependent upon the other and, at the same time denies its existence. The thrust of the indeterminacy critique is that it is impossible to generate principled, coherent doctrine.

From a different perspective, Unger (1987) offers a sociologically informed critique of liberal legalism which stresses the importance of the indeterminacy of both legal doctrine and social context. Unlike the indeterminacy critique advanced by Duncan Kennedy, which posits an irreducible conflict between world-views, expressed in the divergence between rules and standards, Unger's theory rejects structuralism; he opens up the possibility of social-structural

¹² Recently, Richard Posner has stated that formalism has three features: (1) a scientific element which defines law in terms of a set of principles and a form of legal reasoning which produces certain outcomes; (2) a formalist element which is static and treats legal principles as if they were timeless and have no chronological ordering; and (3) a conceptual vision which separates life from law. While there are both natural law and positivist versions of formalism, Posner argues that the common thread is the view that one's conclusions follow from one's premises (Posner 1990:15-16). For a critique, see Fish 1990:1458-9.

¹³ Kelman (1987) offers a powerful critique of Kennedy's distinction; for a sustained analysis of Kelman's own version of the indeterminacy thesis, see Kress 1989: 310-20.

change, accepting that there is no constant human nature. For Unger the law is contradictory and indeterminate because the liberal forms cannot be maintained as a result of the transformation of the state into a modern regulatory state. Unger argues that the breakdown of the nineteenth-century liberal legal order, and the transition to the regulatory law of the welfare state, leaves the law caught in a contradictory logic: on the one hand, the political requirements of the welfare state have been absorbed into the law in terms of goals and purposes which are realized through administrative discretion; and, on the other hand, the classical private rights complex functions with different techniques to penetrate the community to accommodate the institutional framework of society. The introduction of social welfare law subverts the formal qualities of classical law (symmetry, certainty, generality, and so on). This combination produces an inability to balance the political demands for results with the classical formalist requirements of the rule of law model. For Unger, paradoxically, the private rights complex originally represented one side of an earlier institutional compromise, one which involved the state granting the elite more control over land, labour and wealth in exchange for allowing the state to develop an administrative system based on taxation and war. Unger's hypothesis is that the origin of the private rights complex is based on a different vision of society from the principles and aspirations embodied in the present system.

The indeterminacy thesis advanced by Unger suggests that an alternative vision of society can be worked out from the implications of indeterminacy, which he defines in terms of conventions and context being indeterminate and the dislocation of objectivity from representation in language. Locating the transformative potential in the notion of 'negative capability', Unger maintains that it is our capacity to break through a specific context of action which presents the possibility for us to reappropriate the alienated political and economic spheres and, at the same time, guarantees the possibility of personal transformation and freedom. Unger insists that the formative institutional context can be transformed through an exercise in deviationist doctrine which involves drawing out the alternative legal vision of the private rights complex in order to demonstrate that certain elements were embedded in deviant forms in past legal arrangements and that these counter-forms avoided instability and, as a result, form the basis of a transformed social institution. However, Unger's deviationist doctrine, and the subversive potential in exploiting contradictions that might shatter the liberal legal order, is limited by the fact that it relies upon the existing norms and ideals in society as the basis for social-structural change.¹⁴

¹⁴ For the most part, Unger's deviationist doctrine is perceived as the least threatening,

The concern of all these theorists focuses on how indeterminacy affects the authoritative decision-maker, usually the judge. There is little or no consideration of the way in which the characteristics of legal rules affect the social behaviour of legal subjects, nor for how this is mediated by lawyers, whose prime role it is to adapt and develop the forms of legal rules and concepts to the social transactions of their clients. We argue that it is important to integrate some of these considerations regarding the indeterminacy of rules with the recent sociological perspectives which emphasize the social structures and function of competitive professions in exploiting paradoxes and inconsistencies in law.

7.7 The Reality Paradox and Systems Theory

Indeed, this point has been advanced, albeit from a different perspective, by Teubner, who argues that the problem with the radical critique offered by critical legal studies scholars is that it 'is not radical enough' (Teubner 1990: 404). The general doctrine of indeterminism, as developed by critical legal studies scholars, focuses only on superstructural phenomena, such as legal norms, doctrine, institutions and decision-making, and, as a result, fails to expose the deeper point that law itself is based on a fundamental paradox.¹⁵ The paradox of legality is that, in order for law to be determinate, it must be grounded in some super-norm.¹⁶ The problem for the rule of law is not to locate a ground (or foundation) of law, since there is no grounding, but rather to suppress the fact that we can generate paradoxical situations, and can accept contradictory opinions as being both right and wrong, which unmasks the disturbing reality that we must invent excuses in order to give authoritative answers. For Teubner, the work of law is to accept paradox, and that reality is paradoxical. The intuition here is that we are always already embedded in a paradoxical world and it would be itself deeply paradoxical to attempt to

and hence most attractive, version of indeterminacy critique, since it provides a foundation for the legitimacy of law within certain aspects of the present normative order (Collins 1987). For a view that Unger is actually a deconstructionist, see Jack Balkin (1990:1688 n. 55, 1689 & n. 57).

¹⁵ Teubner, following Luhmann, argues that the legal system has no foundation and that paradox, self-reference, indeterminacy, etc., are part and parcel of the operation of the legal system (Teubner 1990: 408-9). Hence, paradox can be grasped by a theory which contends that reality has a circular structure and there is no insight gained from attempting to seek solutions by avoiding paradox.

¹⁶ Interestingly, Luhmann and Derrida both refer to Walter Benjamin's classic essay, '*Zur Kritik der Gewalt*' to support their claim that 'there is no such right above right and wrong, no such superright' (Luhmann 1988b; 154; Derrida 1990).

locate or construct a de-paradoxical reality. Thus, the best way to avoid the perversion of paradox is to suppress the fact that law is founded on originary violence or power.

For Teubner, legal decisions are not based on any super-norm of justice; the system merely sorts claims on the basis of a simple binary code, legal-illegal. The simple process of differentiating legal from illegal acts necessarily involves the suppression of the paradox of self-reference. That is, the judge must suppress the truth that there is no right or wrong, in order to follow the dictate of the binary code that a wrong be constructed. The proper role for the interpreter is to avoid the problem of locating a transcendental ground for law. The fact that the legal system is able to process these demands routinely, and without creating legitimization problems in every instance, is what makes it function.

Teubner argues that the function of contemporary theory is not to offer a general account of legal contradiction or paradox. No such theory is possible since there are no practical solutions to the fundamental indeterminacy of law. For Teubner, the proper task for the radical indeterminacy critique is to extend it to understand that there are classes of legal indeterminacy which arise from other sources than the paradox of the legal system. Teubner understands the emergence of the new indeterminacy as being instantiated in balancing tests, the increased propensity to employ general clauses in contracts, and the emergence of sociological and economic-based jurisprudence (Teubner 1990: 410). For Teubner, the relevant theoretical perspective for extending the indeterminacy critique is autopoietic theory, since the problem of indeterminacy is important at the level of system's own communicative contexts. In this regard, Teubner, unlike critical legal studies theorists, attempts to ground the indeterminacy analysis at the level of real operations within society. For Teubner, indeterminacy is created when a communication sub-system adapts to another system's self-description. Indeterminacy is a function of the interaction of autonomous but overlapping communicative contexts; while the internal codes which ensure self-reproduction remain intact, the interference that results creates conflict between the system and operation of its environment, and the influence of the environment within the system.

Teubner views the legal system not as a coherent whole, but a series of self-enclosed sub-systems reflecting the functional differentiation of society; thus, conceptual and normative conflicts between the sub-systems are unavoidable. It is the very indeterminacy of legal principles, such as general clauses in contracts, that provides the mechanism for reconciling the conflictual logics of sub-systems. The high degree of flexibility manifested in these clauses, for example 'good faith' clauses, provides an efficient mechanism for reconciling the legal disputes between the various sub-systems (Teubner 1990). Diverse social demands and conflicts, resulting also in state intervention, produce the

materialization in private law of general clauses, which provide the legal means for co-ordinating contradictory social demands. Unlike critical legal scholars, Teubner concludes that legal indeterminacy is a functional mechanism which ameliorates the disabling effects of the paradox that there is no foundation for law. That is, the legal system is capable of creating internal mechanisms which stabilize the intersystemic conflicts, through the recursive self-generation of 'eigenvalues' which creates the potential of social regulation through law (Teubner 1990: 408-9, 420-5; see also Teubner 1992).

However, the systems theory approach concerning indeterminacy is problematic in several respects. While indeterminacy is clearly a prominent feature of regulatory systems, this does not mean that reality itself is inherently paradoxical. Zolo argues that '[a]ttributing to "reality" a circular structure not dependent on (the circularity of) knowledge amounts to violating the premise of the circular and "closed" nature of the cognitive process' (Zolo 1991: 77). As regards the claim that law is a closed system — closed off from external sources and capable of reproducing its own operations through its own structures — the basic question is whether autopoietic systems are indeed self-regulating.¹⁷ To suppose that reflexive autopoietic structuring can obtain stability suggests, as Frankenberg has argued, the emergence of an invisible hand which operates to produce stability and order from chaos (Frankenberg 1989: 382). According to Frankenberg, systems theory, by employing the concepts of structural coupling and interference, creates the possibility of reforming self-contained systems. The problem is that Luhmann and Teubner, on the one hand, wish to enclose the legal system, but on the other hand, insist that it be sufficiently open to different operating principles in order to create the conditions for internal reconstruction. Nevertheless, despite the limitations of systems theory, the attempt to locate indeterminacy within the material realm constitutes in some ways an advance over critical legal studies' formulations.

¹⁷ Teubner acknowledges that the recursivity of the legal system creates a problem for societal regulation. Briefly, the problem is that external intervention within the legal system creates a regulatory trilemma: i.e., regulation creates disintegration (institutional death); is irrelevant; or corrodes the social sphere (see Teubner 1987: 21).

7.8 Bourdieu: the Generation of Normativity through Social Practices

A sophisticated post-structuralist sociological approach is provided by the work of Pierre Bourdieu. For Bourdieu the autonomy of law results from the competitive struggle of lawyers to assert their influence in the social system by asserting the right to declare or state the law. Thus, lawyers generate the abstract and formal principles characteristic of legal norms and doctrines, and their special knowledge of these principles, and skill in operating the distinctive linguistic processes of the law, guarantee both the autonomy of the legal field and the monopoly of lawyers' access to it.

The body of legal doctrine is, for Bourdieu, a symbolic order which at any particular moment delimits what is possible; although legal doctrine appears, due to its autonomy and its abstract and formal nature, to be a closed and coherent system which generates outcomes from its own internal logic, it does not, according to him, possess the principles of its own dynamic. Both this dynamic, and the conditions of existence of legal reasoning, derive from the operation of the objective relations between agents and of the institutions of the legal field. Thus, the legal test is the focus of struggles because its interpretation is a means of appropriating and influencing the symbolic power which it contains; however, this is not a closed hermeneutics, since the interpretation of legal texts must have a practical effect. Although jurists can put forward competing interpretations, they must operate within the hierarchy both of institutions and norm-sources which defines the authority of legal decisions.¹⁸ At the same time, the competition between interpreters in putting forward their versions and developments of legal doctrine is limited by the necessity of presenting them as rational interpretations of recognized texts. Bourdieu describes the ways in which the two major effects of neutralization and universalization are produced by the characteristic linguistic procedure of law, such as the use of passive constructions and impersonal phrases; far from being a simple ideological mask, this rhetoric is the result of the continual process of rationalization which has over centuries constituted the universalizing posture which is the spirit of law.

While Bourdieu provides a very strong explanation of how the legal sphere is constructed, he is much less clear on why abstract formal rules play such an important part in the reproduction of social relations. He presents a very Weberian view that legal rationality offers predictability and calculability

¹⁸ Also, the juridical field has its own rules and conventions which must be accepted by all participants. Its fundamental principle is that all conflicts must be resolved juridically; beyond this, the three main requirements, Bourdieu says (1) that decisions are binary (e.g. guilty/not guilty), (2) claims must be couched in the procedural terms which have become historically accepted, and (3) precedents are authoritative (Bourdieu 1987: 832).

(Bourdieu 1987: 833). Yet Bourdieu himself accepts the Legal Realist critique that rules can never be merely applied to new cases, and that texts 'can go so far as complete indeterminacy or ambiguity' (ibid.: 827). For him, it is this indeterminacy which gives not only judges, but more importantly the various groups of competing legal professionals, the power to explore and exploit it by using their resources and techniques to generate alternative rules which they can wield as symbolic weapons. If the promise of consistency and predictability offered by the formal-rational nature of the legal universe is illusory, whence comes its legitimacy?

For Bourdieu the power of law seems to derive from the effectiveness of legal symbols in giving the 'seal of universality' to social practices (ibid: 845). Legitimacy is imposed in the social order through symbolic domination. In explaining how the promise of predictability is fulfilled, Bourdieu again emphasizes the social practices of professionals. Here he introduces his key concept of the 'habitus':

the juridical field tends to operate like an 'apparatus' to the extent that the cohesion of the freely orchestrated habitus of legal interpreters is strengthened by the discipline of a hierarchized body of professionals who employ a set of established procedures. (Bourdieu 1987:818-19)

The habitus is defined as 'the system of dispositions to a certain practice... an objective basis for the regulation of behaviour, and thus for the regularity of modes of practice, and if practices can be predicted... this is because the effect of the habitus is that agents who are equipped with it will behave in a certain way in certain circumstances' (Bourdieu 1990: 77). Note that the habitus, which is constituted by second-order objective structures, is the repository for the strategies of distinction which varies actors employ in their struggles with and against other actors within the autonomous field.¹⁹ Serving as the mediation between external structures and action, the habitus 'est createur, inventif, mais dans les limites de ses structures' (Wacquant, in Bourdieu 1992: 26).

Thus, the repertoire of behaviour is structured and limited by the habitus,

¹⁹ Bourdieu states: 'Between the system of objective regularities and the system of directly observable conducts a mediation always intervenes which is nothing else but the habitus, geometrical locus of determinism and of individual determinations, of calculable probabilities and of lived-through hopes, of objective future and subjective plans. Thus, the habitus of class as a system of organic and mental dispositions, of unconscious schemes of thought, perception and action is what allows the generations, with the well-founded illusion of the creation of unforeseeable novelty or of free improvisation, of all thoughts, all perceptions and actions in conformity with objective realities, because it has itself been generated within and by conditions objectively defined by these regularities' (Bourdieu 1968: 706).

although it permits a range of creative invention which obeys a practical logic. Bourdieu argues that the notions of the field and of habitus must be understood as interactive concepts in order to avoid the twin charges of determinism and functionalism (e.g. Bourdieu 1992:102-15). Thus, he states that the habitus becomes active only in relation to the field and that the habitus may generate a different trajectory of strategies depending on the state of the field (Bourdieu 1990: 116-19). However, it has been argued that Bourdieu presents an 'unrealistically unified and totalized concept of habitus, which he conceptualizes as a vast series of strictly homologous structures encompassing all of social experience' (Sewell 1992: 16). The habitus, which is responsible for the social dispositions of agents and for framing the range of possible actions has a strong conservative bias. This rather static concept is unable to explain how change occurs internally to itself. Thus, Sewell argues, 'Bourdieu's habitus retains precisely the agent-proof quality that the concept of the duality of structure is supposed to overcome' (ibid: 15). Bourdieu's requirement that these structures are all homologous is far too demanding, because society is not so cohesive and there is a range of competing and overlapping structures. Hence, a more dynamic account of change would loosen the strict requirement for homology between the symbolic struggles within the juridical field and the political and economic transformations occurring outside it.²⁰

Within the juridical field, Bourdieu argues that it is the legal scholars and theorists who generate the formal abstractions whose universalizing tendency is the source of the symbolic power of law. Judicial interpretation adapts these general rules to particular cases.²¹ But above all, Bourdieu emphasizes the role of competing groups of practising lawyers and other professionals, who mediate the application and development of formal rules to social practices and

²⁰ To take a contemporary example, Dejalay argues that the internationalization of capital and the deregulation of financial markets in the 1980s have stimulated a response by the most powerful players in the legal field (Dezalay 1992). The new technological developments, and the movement of firms across jurisdictions, is linked to the relative position of each group of lawyers in the juridical field, and their ability to obtain sufficient resources to create new devices for exploitation by their clients. This appears to function as a structural explanation, without sufficient regard either for the improvisational activities of lawyers, which help to mediate the social conflicts, or for the structurally complex role of states.

²¹ In certain respects, Bourdieu is influenced by Wittgenstein's work on rules, although he often says that the reality of practices is a richer source for understanding the social fields (e.g. Bourdieu 1990: 59-75). We believe that Bourdieu's notion of indeterminacy is broadly consistent with the community consensus reading of Wittgenstein since it looks to the social-cultural features of rule-following over the internal, grammatical aspects (Bourdieu 1986: 826).

reality, by marshalling varying degrees of technical skill and social influence.

For Bourdieu the indeterminate nature of legal rules is central, since it is the source of the power of professionals as mediators between the realm of formal law and the economic and social practices of their clients. Bourdieu's focus on the practices of competing professional groups, with varying degrees of skill and symbolic capital, provides a very different perspective from that of critical legal scholars. As Coombe has argued, Bourdieu's position avoids the problem of essentialism which besets the structuralist theory offered by Kennedy, and by interpreting the legal field in terms of conflicting struggles among competing legal actors, Bourdieu achieves a dynamic notion of legal practice; one that is defined in terms of the social dispositions and norms of the competitors which are shaped and structured by struggle (Coombe 1989:103-11). Bourdieu's theory of the juridical field constitutes an advance on the views advanced by critical legal studies because he examines the practices and dispositions of habitus and explains them in terms of the objective elements of social life. Bourdieu clearly understands that the juridical field shapes and structures the dispositions of legal actors and that legal rules are predictable largely as a result of the homogeneity of the habitus. Thus, the law is determinate to the extent that diverse groups within the juridical field accept the legal conventions. In this respect, Bourdieu offers a theory of legal constraint based on the cultural practices that shape the legal habitus (cf. Balkin 1991:1149-53).

Bourdieu acknowledges that Luhmann's notion of self-reproduction of a sub-system is superficially similar to his own concept of the autonomy of fields (Bourdieu 1992: 79), in that differentiation and autonomization are central to the respective approaches. However, he parts company with systems theory by rejecting its functionalism and organicism.²² Bourdieu considers that Luhmann makes a simple category mistake by confusing the symbolic domain with the social field in which it is reproduced. Bourdieu's claim is that the juridical field is only potentially autonomous since, on the one hand, it is structured and shaped by its own norms and practices, but on the other hand, it is influenced by social, cultural and economic forces outside it. In this regard, Bourdieu's account, unlike systems theory, is capable of explaining how legal actors are affected by extra-legal forces and how struggles outside the juridical field are refracted into the field. While we have seen that Luhmann and Teubner see law as a closed system which is in contact with the external environments, but only learns and re-structures from perturbations produced within the system, Bourdieu's notion of the autonomous field requires

²² Elster has argued that Bourdieu's symbolic theory also has functional explanation at its core (Elster 1983: 105-106); but see Bourdieu (1990: 106-19).

a social process of intermediation in the confrontation of texts and procedures with the social realities that they are supposed to express or regulate (Bourdieu 1987).

Bourdieu's theory of the legal field offers an important approach for understanding indeterminacy since it accounts for regularity and predictability in legal doctrine largely in relation to the social structures which constrain and structure legal rules and their application. Bourdieu's approach avoids the structuralism of certain critical legal studies approaches while at the same time it does not reify the legal system or suppress the importance of possible external sources of critique.

7.9 Beyond Bourdieu

Bourdieu provides a powerful account both of the characteristics of legal reasoning and of the conditions and processes of its production, which goes a long way towards an explanation avoiding the dilemma between idealism and economism. However, we would like to indicate what we consider to be weak points in the argument, and develop the analysis in the context of the study of business lawyering. The central problem is with Bourdieu's account of juridification and of the relation of the lay person and of social 'reality' to the legal field. His claim is that this relationship is structural, in that the process which he identifies as the main dynamic of autonomization of the legal sphere is the 'spontaneous logic of competition' between agents asserting specific competences. We argue that Bourdieu over-stresses the role of the professional in the autonomization of the legal field, and under-emphasizes the social need for law and the contribution that law makes in the reproduction of social reality.

In Bourdieu's account, the world-view of order offered by law is powerful yet illusory. The social power of legal professionals derives from their ability to create a demand for their services by offering a world-view of an order based on universal norms and the neutralization of particularisms, and in transforming irreconcilable conflicts of interest into an appearance of exchanges between equal subjects regulated by rational argument between independent professionals before a neutral arbiter. But the offer is a spurious one. First, the capacity to perceive an incident as an injustice, which is the source of the demand for law, is not 'natural', but the result of a construction of social reality mainly by professionals generating the feeling of entitlement, the revelation of rights (Bourdieu 1987: 833). Second, the elasticity and ambiguity of legal texts means that judicial decisions involve an element of choice which is either arbitrary or derives its content externally, from the social or economic preferences of the judge. The conformity of decisions with the system of abstract rules is essentially an ideological matter, reinforcing the

symbolic power of the legal sphere, which is exerted by the social acceptance of the decision as legitimate despite its arbitrariness. The practical efficacy of a legal decision, for Bourdieu, rests in its applicability in the everyday realm where the matter originated. This double function of law produces two poles around which the types of lawyer coalesce: on the one hand, the theoreticians, whose role is the elaboration of pure doctrine, and on the other, the practitioners, who take care of the necessary adjustment of pure principles to social reality and for whom the interpretation of law must be evaluated by its applicability to the particular case.

To begin with, an empirical objection can be made, that this distinction in roles appears based on the continental European tradition, in which judges or magistrates tend to decide on the basis of the practicalities of the situation, while academic lawyers are the guardians of the purity of doctrine. In contrast, in the common-law tradition, particularly in English law, it is the judiciary which tends to emphasize legal autonomy, especially from politics, and the importance of basing decisions on doctrinal exegesis, whereas academics often criticize their judgements for failing to take into account social 'reality' or practical implications.²³ However, the existence of two 'poles', of pure and practical law, is a structural requirement according to this theory, hence it is not of major concern which particular group carries out either function.

A more fundamental difficulty is that, in identifying power with the control of access to legal resources, Bourdieu treats control as concerned exclusively with the ability of certain social agents to appropriate conflict. In contrast, an examination of situations in which social actors actually do invest resources to improve their access to legal sphere shows that by doing so they do not challenge the autonomy of law, although they may increase their control over lawyers. Though members of the dominated classes generally have low access to law, they can in some circumstances become specialized in aspects of concern to them: for example, in the case of 'jailhouse lawyers' who develop specific skills in the filing of appeal petitions and other procedures (Milo-

²³ These differences caused similar difficulties for Weber's theory of legal formalism, the famous 'England problem'. Bourdieu himself argues that the French and German Professorenrecht is based on the primacy of doctrine over procedure, whereas the Anglo-Saxon case-law system emphasizes procedural fairness and aims for a solution to the particular case without much concern for its basis in a moral or scientific rationality; this distinction he sees as rooted in the greater importance of practice both in legal training and in the recruitment of judges (Bourdieu 1987: 822). The argument is further developed by Dezalay, (1986) who argues that the theoreticians of pure law have a stranglehold over the reproduction of law, which they codify and rationalize on the pretext of drawing out general and abstract rules by purifying them of ordinary language, dispossessing and downgrading practitioners, a picture which does not easily fit the common-law world.

vanovic 1988). More central to our concern with business lawyering is the growth of in-house corporate law departments, which permit a large firm to internalize routine legal aspects of its transactions and create a better basis for it to evaluate and control its external legal contracts (Chayes and Chayes 1985). To be sure, it can be said from a Bourdieuan perspective that this 'competition' from the periphery of the legal field merely pressurizes independent lawyers to invest further in legal autonomy and rationality. Our point, however, is that such investment must show an economic return and cannot be based on a merely ideological power. Large corporations, especially when they have their own in-house counsel and are dealing with others similarly situated, do not resort to outside lawyers only due to acceptance of the ideology of professional autonomy. The in-house counsel movement has certainly had a strong disciplinary effect on the legal profession in the US, and probably does so also in other countries, such as Germany where bank lawyers play an important part in business lawyering (Hartmann 1991). In the US the evidence is that internalization of legal services was part of the general trend of pressures on corporate management from capital markets to reduce costs, with the end of the era of uninterrupted corporate growth. Internalization reduced the costs of much routine work and capped expenditure on some outside work, notably litigation, but stimulated new areas of work for the independent firm, in specialized transactions, regulatory work and the breakdown of business relationships (Chayes and Chayes 1985). This has led to the emergence of new 'boutique' firms and undermined the old general-purpose commercial law practice, creating new tensions between the professional ideal and the increasingly bureaucratic organization of the elite law firm (Nelson 1988).

Both the example of the jailhouse lawyer and the corporate in-house counsel show that the client is not structurally excluded from the legal field, but can develop independent legal expertise, either where it is economic to do so, or where there may be another gain, for example in social prestige (e.g. in the jail). Bourdieu's account offers a distorted characterization of the power of the juridical field to exclude lay persons. In our view it is necessary to accept that, since social relations are reproduced partly through law, social actors are always already (partly) within the juridical field; but they possess varying degrees of skills, time, resources and inclination to monitor the legal professional.

For Bourdieu, the main effect and purpose of creation of the legal space is to secure a monopoly for lawyers, who have invested in the acquisition and the generation of the specialized knowledge and techniques, and to exclude the lay person, whose everyday, commonsense understanding is confronted by a sharply different mental universe. Largely a by-product of this alchemy is the neutralization effect, in which irreconcilable conflicts of interest are transformed into regulated and rational arguments between equal subjects or parties.

This embodies a vision of social order, backed by state powers and sanctions, which by its symbolic force consecrates and helps to create the social world. Its force is symbolic, in that it can only be effective if it is accepted even by those whom it dispossesses. In Bourdieu's account there is a dual basis for this effectiveness. On the one hand, it is essentially ideological, in that the vision of order projected by law, which is a universalist one transcending particularisms, is merely a deception since its pure principles must be adjusted to reality by arbitrary or political judgements. On the other hand, he accepts that there is a social reality to the symbolic efficacy of 'formal rational' law, and that it does provide predictability and calculability, as argued by Weber. However, these features of the formal rigour of law are only available to those who can gain access to the specialized realm of pure law.

Hence, the powerful reinforce their positions through law in two ways. First, because the judges and others with legal competence come from the same social stratum and share their ethical and political dispositions, their interests are more likely to be reflected in the process of adjustment of pure law to social reality. But second, to the extent that pure law can offer a realm of formal rationality, access to these advantages is the privilege of those who can purchase legal advice. Although a shift in the balance of social forces in favour of dominated groups can produce a differentiation in the legal sphere, by the introduction of consumer law, labour law and social law more generally (with an emphasis on public as against private law and the creation of special tribunals as against the general civil courts), this is essentially integrative. For Bourdieu, law is essentially conservative; although he says law creates the social world, it does so on the basis of existing structures, since its effectiveness depends mainly on its being adjusted to those existing structures. A creative or prophetic vision is possible, especially in periods of revolutionary crisis, but generally even a creative vision of law can only consecrate a process which is under way. Hence a critique of law, and the generation of a basis for social change, must be sought outside it. So for Bourdieu, as for many other sociologists of law, law is internally coherent and in its own terms rational; the problem lies with restricted access. His position is on the radical wing, in that the implications of his position are not that access should be improved but that law should be abolished.

We argue that Bourdieu's picture of the realm of law can be brought into a different focus, with different implications, by accepting that the legal sphere plays its part in the reproduction of social reality by interactions with other equally fetishized spheres, notably the economic realm, which is mediated by money. To the extent that the legal sphere contributes to the reproduction of social relations it has a functional and not merely illusory role; however, there are deep structural contradictions in this role, a distorted reflection of the broader social contradictions. The process of abstraction by which legal

reasoning produces and elaborates formal legal rules results in norms which purport to regulate social conduct; as Bourdieu correctly points out, their abstract nature entails indeterminacy, since they can only receive substantive content by interaction with other social spheres. Nevertheless, this indeterminacy is functional, in that it provides the flexibility and adaptability which permits law to contribute to the dynamic of social change. We do not say that this is necessarily a positive or ameliorative dynamic; simply that social change is generated partly through law, and hence that lawyers can play a creative or contributory role in such change.

7.10 The Regulatory Process and the Dynamic of Business Lawyering

In this section we pull together some of the points made until now, and sketch out a framework for the analysis of business regulation and lawyering, which will be applied in the final section to the specific example of the regulation of financial market transactions and the prohibition of insider trading.

Markets cannot exist without rules, and the regulation of market transactions takes place through layers of rules, formal and informal. Rules emerge through the need to mediate economic transactions by reference to a framework of generally understood and articulated expectations about behaviour and conduct. Regulation is essential to the operation of any system of social organization; but the generalization of social relations mediated by commodity circulation resulted in the autonomization of the state, which legitimizes the definition and allocation of property rights, and ultimately guarantees the enforcement of those rights and their circulation. It is the combination of economic relations mediated by markets, and political processes dominated by the state, through which social relations are reproduced. That combination is mediated primarily by money and by law.

This is not an automatic process, nor one that flows logically from the development of economic and social relations. Hence, it is important to understand the ways in which the forms taken by social and economic activities have developed historically, and the role that regulation has played in that development. There is no space here to give more than a brief indication of the main phases of development of the regulatory frameworks which have helped mould the institutional and transactional patterns of corporate capitalism. The key formative period of 1865-1914, between the American Civil War and the First World War, was marked by the great depression of the late 1870s and early 1880s, which stimulated the concentration of capital and the establishment of the first large-scale major companies. During this period, the leading capitalist countries established the basic legal framework for the institutionalization of corporate capital, through the liberalization of the right to incorporation and of the main institutions of property ownership and trans-

fer, including industrial and intellectual property rights. Although there was significant international discussion and debate, and cross-jurisdictional transplantation and emulation, there were significant national divergences. Notably, while the US, during the 'progressive era' evolved a liberal 'regulated corporatism' (see, e.g., Sklar 1988), elsewhere the state played a more direct role: in Germany, within a formalized framework, which included state-supervised cartels, whereas in the UK the longer history of the centralized state and greater homogeneity of its ruling groups permitted much more informal supervision of business and industry. These patterns were generally further consolidated during the 1930s, following the crash of 1929, notably with a significant revamping of the US regulatory arrangements during successive Roosevelt administrations, especially the establishment of the Securities and Exchange Commission in 1933-4, and the revitalization of antitrust law enforcement after 1937. After 1945, American influence led to some regulatory transplantation, especially of antitrust laws (for example, to Japan and Germany), but as the post-war boom gathered momentum after the end of the Korean War, the regulation of the institutions, structures, practices and transactions of business was of relatively small concern. The period since the mid-1960s has seen a trend towards formalization or juridification of business regulation in many fields. It has also been marked by international conflicts of regulation, resulting from the application of national regulation to increasingly internationalized business (Picciotto 1983). Finally, during the 1980s, although there has been a significant process of national deregulation, it has been accompanied by equally important patterns of and attempts at re-regulation, to establish internationally co-ordinated controls over global business.

From this brief outline it should be clear that the development of regulation takes place in response to both political and economic processes. While major events, such as war or depression, have broad political repercussions and often lead to radical changes in regulatory forms, the continual operation of economic and political processes also produces changes, generally at the micro level. A key failure of legal regulation within capitalist market economies generally is that they aim to produce and maintain equalization of the conditions of competition: hence their basis ideal or feature is equal treatment or rule-fairness in relation to similarly situated economic actors. However, competition is not a static state but a process. Furthermore, economic actors are quite different in their factor endowments, market power and sunk investments, so rules affect them differently. Moreover, the very operation of a regulatory system produces inequalities resulting from competitive advantage. Hence, an important function of the process of interpretation, application and enforcement of rules is to resolve the persistent antinomies resulting from rule-structured market transactions. For that reason, a regulatory system by nature is not a static but a continually evolving and dynamic process. The interpreta-

tion involved in the application of rules to specific transactions generates modification, supplementation and amendment.

A key role in this process is played by the private lawyer whose job is to structure a client's business strategies and transactions to optimal advantage in relation to the regulatory framework. This often involves routine 'compliance' work, ensuring that transactions conform to the bureaucratic formalities of the regulatory arrangements, or are kept within the accepted understandings of the regular players. Not infrequently, however, often in small and sometimes in major ways, the lawyer may play a 'creative' role. This may entail, for example, achieving an economic objective desired by the client, which is impeded by a regulatory obstacle, by devising a new legal means; or the lawyer may find significant cost-savings for a client by new ways of structuring a transaction, by creating new legal forms or adapting existing ones to new ends. Such creativity can lead to the development of major new legal and institutional forms (such as the holding company), as devices become generalized through competitive legal practice. However, legal 'creativity' raises constant ethical, political and economic (as well as legal) issues, as it probes the limits of the existing regulatory patterns.

The problem of regulatory compliance is the chief concern for state officials. As we have seen, legal theorists and economists have addressed the problem of rule avoidance and compliance in terms of the conflict between rules and their interpretation. Until recently, regulatory theorists assumed that legal rules were common knowledge and that there were static incentives for compliance. The static rule framework was based on the view that legal rules were fixed and assertable and that parties self-select, given their preferences, to follow the rule. As we have noted above, modern legal theory has pointed out that legal rules are moderately indeterminate, and that the uncertainty in legal rules results from the competitive struggle to define the rule and the fact that interpreters can, within certain boundaries, select an interpretation. In this perspective, legal rules are the result of interpretations of regulators and judges who justify their decisions with the aid of rhetorical practices (Fish 1993). This contingency of law leads some CLS theorists to infer that law must therefore be politics and hence illegitimate; whereas it delights pragmatists, like Fish, who argue that it reflects the inherently contingent and historical quality of interpretation generally. The implication for regulatory theory is that indeterminacy permeates the regulatory domain and there is always movement in the juridical field to assert new interpretations in order to modify the impact of legal rules.²⁴

²⁴ Even law and economics scholars have tried to integrate some of the insights of the post-realist jurisprudence; thus, Jason Scott Johnston has examined the problem of legal

7.11 The Regulation of Insider Trading

Against this background, we now turn to discuss the role played by business lawyers in mediating some of the changes in the financial services sector, focusing especially on the major scandals in the US during the 1980s and the debates about the interpretation and enforcement of the 'insider trading' rules.

7.11.1 Risk, Trust and Property in Information

As in any area of economic regulation, the role of legal rules in mediating, financial transactions is expected to be to ensure a 'level playing-field'. The demands for fairness, in this context, result from expectations underpinning the functioning of financial markets (Giddens 1990: 247) and their accompanying regulatory institutions. Financial market transactions, like all exchanges, require a basis of trust between the parties; this is especially important since such trading is particularly impersonal, taking place between parties who may not even know each other's identities, and particularly abstract, since it concerns subject-matter with little content other than price. In such circumstances, trust is only possible if risk is kept within acceptable limits (Luhmann 1988a: 36-46).

Perhaps the most important force driving financial markets is information. It is not surprising, therefore, that rules governing the disclosure of information should be central to the stabilization of expectations about risk, and thus to the maintenance of the basis of trust necessary for the functioning of such markets. However, the issue of information disclosure involves a central contradiction. Profitable trading results from capturing the value of private information, which would be negated by disclosure; hence, an obligation to disclose removes the economic incentive to acquire information, and would impede the flow of active trading (Fischel and Ross 1991: 509) by participants who believe they have advantageous knowledge or superior analysis. On the other hand, many investors would be repelled from markets if they perceive them to be 'rigged' by privileged knowledgeable insiders.

Hence, it is in the characteristics of financial market transactions themselves that can be found both the need for rules, as a means of reconciling expectations and creating trust, as well as the reasons for their instability. The market requires a regulatory framework, *inter alia* to define the legitimate limits of property in knowledge. The abstract and formal nature of the rules helps to legitimize the terms of trading, while their relative indeterminacy provides the

uncertainty, and argues that legal form oscillates 'from precision to generality, between rules and balancing' (Johnston 1991: 365).

flexibility which can accommodate divergent expectations between the parties. The particular skills of legal professionals lies in acting as intermediaries between the realm of abstract-formal legal rules, where the general interests of market participants is debated and reconciled, and the practical realm of specific transactions, where the professional can and must exercise the creativity permitted by the ambiguities and indeterminacy of the rules to facilitate a deal or resolve a conflict caused by a failed transaction. As this creativity is also used on behalf of clients in the competition between market participants for competitive advantages, it can contribute to the destabilization of the regulatory system which results from the dynamic of the markets.

7.11.2 The Origins and Basis of the Prohibition of Insider Trading

Historically, trading in financial securities was regulated only under the general law of contract and fraud. The emergence of a more specific regulatory regime took place in the US, following the general loss of confidence due to the collapse of the stock market in 1929, and the resultant widespread lack of trust and generalized belief that dishonesty permeated the financial markets. The need for regulation to restore confidence was argued by eminent lawyers who were also public figures, notably Brandeis, who published a critique of Wall Street (*Other People's Money*) in 1933. Congress enacted legislation in 1933 and 1934 which regulates the issuing and registration of securities (Securities Act of 1933), and the purchase and sale of securities (Securities Exchange Act of 1934). The 1934 Act also established the Securities and Exchange Commission, a regulatory body of a fairly classical corporatist type: the Commissioners are eminent professionals who direct the policy, while the official staff are charged with its implementation.

The main target of the legislation was market 'manipulation'. However, this is a far from precise concept, and defining its scope involves significant economic and political issues, as well as affecting numerous vested interests. The legislation of 1933-4 included several specific provisions outlawing particular practices. Thus, s.16(a) of the 1934 Act required corporate executives to register their holdings of the company's stock, while s.16(b) introduced the 'insider's short-swing profit rule' requiring such insiders to disgorge to the company any profits from trading in its securities within a period of six months. The 16(b) rule was very narrow and easily avoided, since it did not cover trading in the shares of related companies, nor tipping, nor 'stringing out' trades beyond the six-month limit. In addition to such relatively specific rules, the 1934 Act also included a sweeping provision (s.10(b)) making it unlawful in connection with any sale or purchase of securities to 'use any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe'.

Whether and to what extent trading with privileged or inside information might amount to or should be treated as fraud was unclear, and had been the subject of some academic and judicial debate. Common law fraud generally required a deliberate and explicit misrepresentation. Hence, mere silence or the failure to disclose was not actionable, unless there was a basis for an obligation to speak, such as a confidential or a fiduciary relationship. Although the *Supreme Court in Strong v. Repide* (1909) had found that the concealment of his identity by a manager purchasing from a minority shareholder did amount to fraud, this seemed based on the special circumstances of a close relationship rather than the mere manager-shareholder link, which made the concealment fraudulent. Some argued that company executives were in a fiduciary position by virtue of which any trading by them in the firm's securities should be regarded as tainted; however, it seemed too extreme to prohibit all trading by executives, and other theorists preferred to point to the need for disclosure by any person (not only managers or employees) trading on privileged information, which could also make avoidance more difficult by limiting the passing on of the information (Manne 1966: ch. 1).

In the face of the inadequacies of narrow anti-fraud rules such as 16(b) and 17(a), the SEC in 1942 approved regulations under the broad powers of s.10(b), including Rule 10(b-5), which much later became a key and hotly contested provision. Within the framework of a still very general rule against fraud, ale 5 made it unlawful:

To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading.²⁵

Initially, this provision was very little used. Overall, the rules and their enforcement merely routinized and normalized the disclosure of holdings by executives, as well as others purchasing large blocks of shares; this favoured larger issues of securities (Easterbrook and Fischel 1991: 277-9). The 1930s New Deal reforms, which involved the delegation of regulation to self-regulatory bodies, including the stock exchanges and dealer organizations, served to eliminate competition and restore political legitimacy to the markets (Moran 1991: 30-1).

It was only in the 1960s, and based on private actions by shareholders and purchasers, that the issue of concealment of privileged information was brought to the fore. By 1965 there had been an appreciable increase in the number of

²⁵ SEC Securities Exchange Act Release No. 3230/21 May 1942), 7 Fed Reg. 3804 (1942) (17 CFR S240.10b-5).

private actions citing s.10(b-5): in 1962-4 the number of cases citing 10b-5 were over 50 per cent more than those for the two prior decades, 1942-62 (Manne 1966). From the 1950s to the early 1970s the SEC contributed very little in the way of control of insider trading, even though it was clear from the empirical studies that there was significant non-disclosed trading on insider information; particularly in the context of unannounced merger plans.²⁶

7.11.3 The Uncertainty of the Disclosure Rule and the Conflict over the Misappropriation Theory

The activation of the obligation to disclose by means of civil actions brought by the SEC, as well as major criminal prosecutions by the Department of Justice, began in the late 1970s,²⁷ resulting from major changes in financial markets. In particular, the opening up of trading in share futures substantially increased the potential value of privileged information, since very little capital outlay was needed to take a position on the possibility of a price movement. At the same time, the financial boom, creating much greater market competition, led to major institutional changes and the arrival of large numbers of newcomers both as employees and major traders. These changes destabilized the previous regulatory regime based on understandings among the WASP leaders of the major financial institutions and professional firms.

While the vast bulk of cases initiated were resolved by out-of-court settle-

²⁶ Early studies showed a strong relationship between insider trading and large price movements (see e.g. Lorie and Niederhofer 1968: 50-2; Pratt and De Vere 1972; Jaffe 1974a). For recent discussions of the statistical evidence see, e.g., King and Roell (1988:173-7; Suter (1989: 912) Susan Shapiro's study of the SEC analysed data on securities violation prosecuted by the agency from the late 1940s to the early 1970s, and showed that the vast majority were apparently technical misrepresentation and registration violations; however, while most of the common types of violation were remarkably stable, some offences, such as professional technical violations and self-dealing, increased. Shapiro concluded that [t]hese trends reflect some mixture of the effect of changing economic conditions, growing sophistication among wayward capitalists, shifting SEC priorities, and the ubiquity of certain generic *modi operandi* of securities fraud and cover-up' (Shapiro 1984: 27 & n 4).

²⁷ The Commission brought fewer than fifty actions in the two decades 1949-1977, but seventy-seven cases between 1982 and 1985, equivalent to all the cases brought in the previous forty-seven years (information from the SEC: see also testimony of its Chair, John Shad, to the Subcommittee on Telecommunications, Consumer Protection, and Finance, of the Committee on Energy and Commerce of the House of Representatives, Hearings on Insider Trading, June-July 274 1986; Naylor 1989). The first criminal prosecution was brought in 1980, after which about 40 per cent of cases were criminal in nature (Naylor 1989: 88).

ment (as is usual in white-collar infringement actions),²⁸ some key actions were litigated to conclusion, exploring the ambiguities and limits of the legal rules. The basis for more active enforcement had been laid in the early 1960s, when William Cary, as Chairman of the SEC, supported the deployment of the judiciary duty concept to establish an obligation on corporate insiders to 'disclose or abstain' from trading.²⁹ The SEC's reasoning was that there was a duty to disclose material information obtained by company executives, employees and others, since such information is obtained in the course of their work which should be to the benefit of shareholders. This still left very open the extent of the prohibition on the exploitation of such an informational advantage. While the more specific rules governing disclosure of share ownership and trading by executives might be too narrow and easily avoidable, a broader rule dealing with privileged information could strike to the heart of the quest for informational advantages which provides an important dynamic for the markets.

Despite considerable doctrinal debate and some major litigation during the 1980s, including several landmark Supreme Court cases, there remains a lack of clarity both in the formulation of and in the rationale behind the insider dealing rule. In *Chiarella v. United States* (1980), the Supreme Court accepted that parity of information between trading parties could not be the aim, stating that 'not every instance of financial unfairness constitutes fraudulent activity under S10(b).'³⁰ The Court noted that the legislative intent of 310(b) did not support the parity of information rule and that 'the problems caused by misuse of market information had been addressed by detailed and sophisticated regulation that recognizes when use of market information may not harm operation of the securities market' (ibid.: 233). The SEC had secured convictions against Chiarella, a 'markup man' employed by a well-known Wall Street financial printer, who by virtue of handling confidential documents for a takeover bid, was able to discern the names of the target companies from information contained in the documents. Acting on these deductions, and without disclosing his knowledge, Chiarella immediately purchased shares in the target companies and thereafter sold them after the takeover attempts were

²⁸ Of the twenty-two Department of Justice prosecutions between 1981 and 1984, twenty-one were guilty pleas; however, of the fifty-five cases brought in the Southern District of New York up to 1987, sixteen defendants pleaded guilty (Naylor 1989: 88; see also Flynn 1992:109 & n. 8).

²⁹ The disclose or abstain rule developed in *Cady, Roberts & Co.* 40 S.E.C. 907 (1961) was later upheld by the Second Circuit Court of Appeals in *SEC v. Texas Gulf Sulphur Co.* 401 2Ed 833 (2d Cir. 1968), *cert. denied*, 404 U.S. 1005 (1971).

³⁰ *Chiarella v. United States*, 63 L.Ed. 348, 359 (1980) (citing *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462, 474-77 (1977)).

made public. The Supreme Court overturned the lower courts' decision, stating that since he was not in a relationship of trust to the shareholders he was under no duty to disclose.

The *Chiarella* decision sparked a heated theoretical debate, and obliged the authorities to shift to a broader-based theory that the duty to disclose was based on 'misappropriation' of information. Chief Justice Burger, in a strong dissenting judgment in *Chiarella*, had argued that, in the context of rule 10(b)-5, what matters is whether a party obtains information through air means or simply misappropriates it unlawfully for personal gain, since such a party should not profit from 'his ill-gotten informational advantage by purchasing securities in the market' (1980 445 US at 245). This appeared to provide a better grounding for a duty to disclose than the existence of a fiduciary relation, which covered only a limited circle of direct employees.

The major test of the misappropriation theory occurred in the litigation following the admission by a *Wall Street Journal* reporter, R. Foster Winans, that he had shared pre-publication information of the details of his column 'Heard on the Street', with a broker in a major Wall Street firm, in exchange for payments to himself and his room-mate, David Carpenter. Winans argued that although he knew that his actions were a violation of journalistic ethics, they were not illegal (Winans 1987: 260). The information essentially concerned the contents of forthcoming columns, hence the decisive moment in the pre-trial tactical manoeuvres was the production by the *Journal's* officers of a 314 page document stating the paper's policy had ever been made known to him, this was the basis on which he and all those who benefited from the information he disclosed were convicted. Although the convictions were upheld by the Supreme Court, on the grounds that the *Journal* had been defrauded of confidential use of its business information, the Court was divided 4-4 on whether the misappropriation theory was a valid approach (*Carpenter v. United States*, 484 U.S. 19 (1987)).

7.11.4 The Enforcement Process and Restabilizing of the Regulatory Regime

Within the framework of the loose and developing doctrinal rules, the regulators conducted a process combining guerrilla war and strategic bargaining with the major Wall Street houses, mediated by the various groups of lawyers involved. By the mid-1980s Wall Street was in the middle of an unprecedented merger wave and a raging bull market. The premium fees that investment banking houses were charging for their services in control contests created further competition and much public debate. There existed considerable public pressure on SEC Commissioners to step up their enforcement against insider trading, especially after the well-publicized Winans case and the persistent

rumours circulating in the financial press that insiders were trading on confidential information in most of the hostile takeovers, which were occurring in greater frequency (Grunfest et al 1988: 311-32). Increasingly, critics of Wall Street's freewheeling approach had begun to link insider trading with hostile takeovers. Congressional democrats were making soundings to step up regulation against takeovers.

A new consensus gradually emerged that financial institutions, in order to promote further competitive gains, required an environment which was free from scandal and based on investor trust. This change in attitude resulted from the recomposition of the investment banking sector which occurred in the 1970s and early 1980s. Stimulated by the competition which resulted after the 1975 SEC decision to deregulate the fixed-rate commissions on stock transactions, investment bankers, affected by the loss of secure profits, struggled to create new markets (Moran 1991: 35-63). As a result, the established investment bankers joined in with the newer investment bankers, like Drexel Burnham, to compete for other firms' clients and to move into the financing of hostile takeovers. These changes upset many of the traditional social and professional relations on Wall Street; but at the same time, the changed commercial environment was threatened by allegations of unfairness which the practice of insider trading promoted in the minds of the public and legislators.

The story of the chain of investigations leading from Dennis Levine through Ivan Boesky to Michael Milken and others, involving a series of major prosecutions, has been widely recounted (see notably Frantz 1988; Stewart 1991; as well as Oliver Stone's film *Wall Street*). Although the underlying issue in these cases concerned inside information, many of the prosecutions were on other charges, such as stock parking or even registration failures. Virtually all the cases were settled out of court on the basis of plea bargains, the negotiation of which is the speciality of the white-collar defence attorneys, who are generally former prosecutors.³¹ The outcome of these, and many other less-publicized cases, has generally been to punish prominent scapegoats, mostly Wall Street newcomers. Nevertheless, this was clearly a traumatic process, not only for the individuals who fell from positions of great financial power and immense wealth to imprisonment and obloquy, but also for their firms, which included some of the leading names of Wall Street.

That said, it is clear that the outcome has been the restabilization of a new regulatory regime based on greater bureaucratization and juridification: the

³¹ Mann (1985). In these cases a key part was played by Harvey Pitt, a former SEC attorney, who defended Bank Leu in the Levine investigation (in the process helping to identify Levine as the scapegoat), and negotiated the plea-bargain for Ivan Boesky which was denounced as a 'sweetheart deal' (Stewart 1991: 296).

'increasing codification of rules, a more prominent role for formally constituted organizations, both public and private; and growing penetration of law into the regulatory system' (Moran 1991: 13). Thus, into the gaps left by the indeterminacy of the general legal rules have been inserted detailed codes of practice, patrolled by corporate compliance officers, who cultivate a close relationship with the official regulators.³² Naturally, their prime task is to ensure that no harm comes to the institutions, and to minimize the number of individuals who may have to be sacrificed. The major financial institutions and market professionals in general terms have an interest in safeguarding their investments in more regularized processes of access to unique information, and in discrediting the more unorthodox and informal channels used by the likes of Levine and Milken.

It is important to stress, however, both that the transition has not been smooth or predictable, and also that the new regulatory regime is far from a being model of formal rationality. In both these respects, therefore, we consider that it is necessary to go beyond a neo-corporatist theory such as that of Michael Moran, who locates the cause of juridification in the institutional structures of meso-corporations and argues that the regulatory struggles of the 1970s and 1980s reflects the response to the ascendancy of multinational financial services firms, which operate increasingly in all major world markets. In Moran's view, the regulatory changes, orchestrated by decisive state interventions, is shaped by the alliance with large market players (Moran 1991: 124-35). While it is no doubt the case that the shifting alliance of private actors and the state is responsible for the changes in regulatory form, we find that Moran's thesis places undue emphasis on almost deterministic changes in state structures, which fails to capture the dynamic and contingent nature of the processes of change. We argue that a key focus must be the interactions of government and private-sector lawyers. Hence, juridification is the result of the strategic competition amongst different players within the juridical field. On this account, the shape of the formal legal rules and the constitution of the juridical field depends, in part, on the specific power of the legal professionals to manipulate power for their interests. It is, however, the competitive interaction between the state and the professionals around the definition of the legal

³² Prior to the massive publicity given to the high-profile insider trading prosecutions, Congress had been satisfied with an enforcement consisting of obey the-law injunctions and administrative remedies imposed by the SEC. However, the 1984 Insider Trading Sanctions Act provided for fines up to three times the profit gained or loss avoided. Even more significantly, the 1988 Insider Trading and Fraud Enforcement Act provided for civil penalties for organizations which fail to take affirmative measures to prevent insider trading by their employees. These powers have produced record sums in terms of disgorgements obtained from defendants (see McLucas et al. 1992: 88-9).

regime which creates juridification. The power of these professionals lies in the specific skills which they control, of mediating the processes of legitimization entailed in relating the realm of abstract rules of law to the specific practices of economic actors. It is the indeterminacy of the abstract rules that leaves the space for creativity, which enables the reshaping of the regulatory regime.

CHAPTER 8

MARKET REGULATION AND PARTICULARISTIC INTERESTS: THE DYNAMICS OF INSIDER TRADING REGULATION IN THE US AND EUROPE¹

8.1 Introduction

The central issue addressed in this chapter concerns transformation of the 'legal field'² of insider trading against the background of the continuing internationalization of financial markets. While a number of factors are responsible for the integration of financial markets in Europe and elsewhere, it is now common to argue that an increase in competition between investment exchanges is solely responsible for the need of national regulators to undertake regulatory reform. Although this insight is important, it is only one factor which explains the impact which changes in international capital markets have had on interest groups and policy in nation states. This chapter aims to place the restructuring process within the broader context of domestic political calculations and the role of interest groups which are linked to, and influenced by, the logic of restructuring in the international market. On balance, where opposing domestic interests are strong, it has been difficult for national governments to pursue a strategy of expending new resources for legislation and enforcement of insider trading regulations.

The second question asked by this chapter is why did European financial centres, which previously did not prohibit insider trading, choose to enact securities legislation designed to restrict the incidence of insider abuses? First, why did politicians promulgate this legislation, particularly since their capital markets had long accepted insider trading practice?³ Given the costs of these

¹ This chapter appeared in Geoffrey Underhill (ed), *New World Order in International Finance* (London: MacMillan, 1997).

² On the constitution of a legal field, see *ibid.*, p. 250-57.

³ Until 1986, only three Member States of the European Community prohibited insider trading. See Raffaello Fornasier, 'The Directive on Insider Trading', in *Fordham International Law Journal*, vol. 13, 1989-9, p. 149.

changes to market 'insiders', why were politicians enthusiastically introducing new obligations when the majority of insiders would, as a consequence, offer them less political and bureaucratic support? Unlike the US, which has long been committed to the regulation and enforcement of insider trading in its capital markets, most European countries had waged a prolonged struggle to maintain the status quo.⁴ It comes as something of a surprise that these states only recently recognized the shortcomings of their established practices and developed specific legal procedures designed to strengthen the reputational capital of their financial centres.

This chapter draws some lessons from the new research in economic theory of inefficient markets and the public choice framework to retell the regulation of insider trading story. Many discussions of the proliferation of insider trading regulation attempt to explain it fully in terms of the need for worldwide uniformity of regulation in order to support and sustain the globalization and integration of capital markets.⁵ The public choice approach adopted here, by contrast, takes account of the features of interest groups, regulators, and political decisionmakers when explaining the emergence of regulation, and places them in a context of distributional conflict. There are two main theories of the role of interest groups role in shaping regulatory outcomes. The simple demand model of 'capture' asserts that lawmaking follows the lawmakers' responses to demand patterns. An additional body of public choice theory supplements this 'demand model' with a 'supply-side' explanation focusing on legislators as 'suppliers' of regulation and regulatory agencies (such as the US SEC in this chapter) as 'intermediaries' between demand and supply sides of the equation. According to this view, the legislators create controls to limit the discretion of agencies and also rely on interest groups, via 'fire alarms', to monitor agency decisions.⁶ Interest groups may 'signal' their preferences to legislators, but since legislators (as the suppliers) have their own preferences, interest groups cannot take for granted that legislators will act in their interests.⁷

⁴ For a general overview of the developments in Europe, see Emmanuel Gaillard, (ed.), *Insider Trading: The Laws of Europe, the United States and Japan* (Deventer: Kluwer Law and Taxation Publications 1992).

⁵ See e.g., Harvey Pitt and David Hardison, 'Games without Frontiers: Trends in the International Response to Insider Trading,' in *Law and Contemporary Problems*, vol. 55, no. 4 (Autumn 1992) p. 199.

⁶ Matthew D. McCubbins et al. 'Administrative Procedures as Instruments of Political Control,' *Journal of Law, Economics & Organization* vol. 3, 1987, p. 243-44.

⁷ David Epstein and Sharyn O'Halloran, 'A Theory of Strategic Oversight: Congress, Lobbyists, and the Bureaucracy,' *Journal of Law, Economics, & Organization* vol. 11, no. 2, 1995, p.236-246.

Any attempt to understand the regulatory process in financial markets must therefore start by examining the role of financial intermediaries. The contention is that the profits of market professionals are squeezed by the presence of insiders trading in the market. It is argued that market professionals, at the beginning of the 1980s, demanded from Congress new rules to restrict the corporate insider trading. Congress saw potential benefits in supplying these new rules, given constituent demands and the state of public opinion in the face of market scandals. Supported by Congress, the SEC in turn proposed increased enforcement in exchange for increased budgets and powers. But the SEC was able to manipulate the situation by providing a framework of rules and enforcement procedures which were sufficiently ambiguous to satisfy its own heterogeneous constituents: market makers demanding change, corporate insiders who were targeted by the new regime, and incumbent corporate managers who wished to limit the power of market makers in takeover battles.

The existing literature has for the most part overlooked the subtleties of these 'supply-side' effects of regulation. I will argue that, in the context of a dynamic field of contemporary banking and financial intermediation, regard for the way in which legislators and regulators combine to supply trading regulation has become increasingly important for understanding the incentives for greater efforts on the monitoring and control of insider trading. The aim of this chapter then is not to propose a general theory of political economy of insider trading regulation, but to suggest that a richer explanation for regulatory reform can only be explained with reference to the local history of the institutional practices and their subsequent adoption.

The chapter is divided into four sections. The first section considers the context in which there has been a sustained demand for the regulation of insider trading. This section traces the origins and development of the US system of enforcement, set up during the period when there was low public confidence in the equity market. This section also analyzes the components of the US approach to insider trading regulation, focusing on the problems of employing Rule 10b-5 measure to control illegal trading. Section two deals with the destabilization of the legal regime and the emergence of demands for tighter regulation of insider trading. It shows that the legislators and regulators as suppliers were constrained by the domestic preferences of interest groups which shape the demand for increased regulation, and that distributional struggle among different types of market actors lay at the root of these preferences. Section three discusses the changes in the competitive environment of international securities dealing. I argue that the erosion of rents through deregulation and competition has led to a new environment in which banks and financial firms operate. The growth of international debt and equity markets, the development of new financial technologies, and financial integration has brought important changes to the manner in which financial transactions are

regulated. Tighter margins and competition have led market makers and institutional investors to square off against corporate insiders, whose activities were proving increasingly costly to the former. This section outlines the SEC's attempt to develop cooperative regulatory strategies, based on reciprocity and harmonization, with foreign securities regulators to achieve greater information and supervision of international transactions. It is suggested that these strategies are limited by national regulatory differences. The final section demonstrates how the EU responded to the same pressures with regard to insider trading in the context of the conflict between supranational authorities and the pressures of interest groups at the national level. This is followed by a brief conclusion.

8.2 Insider Trading Regulation in the US

8.2.1 The Regulation of Information

In this section I survey some main legal and economic models dealing with the regulation of insider trading. One of the most important variables distinguishing the regulation of financial markets in Europe versus America is existence in the US of the Securities and Exchange Commission (SEC) and the very different approach to basic notions of 'fairness' represented by its regulation of insider trading. In the US, the demand for fairness originally emerged from expectations underpinning the functioning of financial markets.⁸ It was thought that financial market transactions, like all market exchanges, required a basis of trust between the parties. This is especially important since financial trading is particularly impersonal, taking place between parties who may not even know each other identities, and particularly abstract, since it concerns subject matter with little content other than price. In such circumstances, it was thought that trust is only possible if risk was kept within acceptable limits. The SEC's early 'disclose-or-abstain' approach was constructed around such a fairness ideal, based on an explicit concern for risk-averse individuals.

Perhaps the most important force driving financial markets is information. The advocates of fairness argued that trading by those with privileged access to inside information was unfair. Accordingly, it was argued that the access to the private information involved a valuable price advantage which other public investors were denied. Quite contrary to the free market paradigm, the 'equal access to information' view argued that the party with superior access to private information should be restricted from trading. Certainly, the less

⁸ Harvey Pitt and David Hardison, *op. cit.*, p. 200.

informed will be at a disadvantage, but only where a market insider actually trades on good/bad news and an uninformed investor has decided to sell/buy.⁹

While rules of disclosure became central to US markets, the issue of information disclosure involves a central contradiction. Profitable trading results from capturing the value of private information, which would be negated by disclosure; hence, an obligation to disclose removes the economic incentive to acquire information, and would impede the flow of active trading.¹⁰ On the other hand, many investors would be repelled from markets if they perceive them to be 'rigged' by privileged knowledgeable insiders. To remedy this problem, it was thought that the mandatory disclosure of information would create a more level playing field for investors and securities firms alike, as the outside investor is unable to overcome lawfully the informational advantage which the insiders possess 'no matter how great may be their diligence or large their resources.'¹¹

However, there are limitations to the fairness approach to the regulation of insider trading. First, insider trading may not be unfair. If outsiders are aware of insiders in the market they will change their expectations and pay a lower price for the shares. There are other advantages which could explain the disparities among traders.¹² There are also a variety of reasons advanced to support the claim that insider trading actually promotes market efficiency. The efficiency theory suggests that if insiders are permitted to trade, they are prone to release valuable information into the market and aid market efficiency by producing more accurate securities prices.¹³ Beyond the relationship between disclosure and performance, the efficiency theory argues that insider trading is justified, given the importance of reducing transaction costs, because it supplies strong incentives to firm managers to obtain information: if the firm does well through lower costs, the managers can compensate themselves while theoretically creating business opportunities for the firm.¹⁴

⁹ Roberta Romano, *Foundations of Corporate Law* (New York: Oxford University Press, 1993) p. 327.

¹⁰ Daniel Fischel and David Ross, 'Should the law prohibit "manipulation" of financial markets,' *Harvard Law Review* vol. 105, 1991, p. 503.

¹¹ Victor Brudney, 'Insiders, outsiders, and informational advantages under the Federal Securities Law,' *Harvard Law Review* vol. 93, 1979, p.354.

¹² Jonathan R. Macey, 'From Fairness to Contract,' *Hofstra Law Review* vol. 13, 1984, p. 15-16.

¹³ Henry Manne, *Insider Trading and the Stock Market* (New York: The Free Press, 1966); Dennis Carlton and Daniel Fischel, 'The Regulation of Insider Trading,' *Stanford Law Review* vol 35, 1983, p.857-895. For a recent empirical study of the stock price effects of insider trading analyzed by the SEC in the 1980s, see Lisa Muelbroeck, 'An Empirical Analysis of Illegal Insider Trading,' *Journal of Finance* vol. 47, 1992, p. 1661-2070.

¹⁴ See, e.g., Paul E. Fischer, 'Optimal Contracting and Insider Trading Restrictions,'

Despite the efficiency argument, there are in fact reasons to suspect that allowing corporate insiders to trade is problematic. First, permitting insider trading may not be particularly efficient in getting information to the market. The management of any enterprise have their own existing incentives to release information and allowing insider trading may alter this incentive structure. In short, permitting insider trading does not ensure efficiency. The efficiency model is also blind with regard to the conflict among market participants over the distribution of economic rents. I therefore turn to another school of thought which focuses on the imperfections which arise out of financial markets. These imperfections create additional transaction costs which in turn create disincentives for large investors.¹⁵ Corporate insiders, taking advantage of their position, in fact acquire trading information costlessly; it is generated by the firm's activity. When corporate insiders use this informational advantage to make gains in trades, this creates losses for market professionals, who must adjust their bid-ask spreads to capture the rents which they are dependent upon. The increased fixed costs which arise from insider trading are passed along to large institutional investors. The distributional consequences of insider trading are therefore: lower returns to outsider investors, reduced incentives for investors to use market makers to access trading information, and potentially reduced liquidity in the market. Although proponents of the efficient market hypothesis argue that no one will be hurt so long as securities prices are efficient and the aggregate levels of insider trading can be estimated by all investors, it is intuitively obvious that lower returns on investment increases the costs to firms. In this regard, the good excuse of lower prices cannot hide the fact that insider trading raises firms' marginal costs and they and investors are made worse off.

To conclude, I have suggested that the fairness argument does not support a reason for insider trading regulation. I also maintain that the efficiency argument cannot be used to support deregulatory policies: permitting insider trading is not an effective means to disclose information to the market nor an effective mechanism to compensate management. The theory of imperfect capital markets, advanced by Glosten and Milgrom, amply supports the claim that insider trading, with regard to market investors, has distributional effects and increases the probability that a market will have less liquidity unless regulators develop efficient means to implement insider trading laws.

Journal of Finance vol. 47, no. 2, 1992, p. 673, 681-4.

¹⁵ Lawrence R. Glosten and Paul R. Milgrom, 'Bid, Ask and Transaction Prices in a Special Market with Heterogeneously Informed Traders,' 14 *J. Fin. Econ.* 1985, p. 71.

8.2.2 The US Statutory Framework

In light of the above section, several questions arise. First, what are the main legal instruments employed to manage the problem of insider trading? Is there any reason to believe that there is a determinate solution, given the complexity of the problem and the political conflict among the groups competing for political and regulatory influence? It is only possible to address these questions if we examine the development of the process and structure built up to deal with insider trading in the United States.

Prior to the Great Depression, trading in financial securities was regulated only under the general law of contract and fraud. Congress enacted legislation in 1933 and 1934 which regulates the issuing and registration of securities (Securities Act of 1933) and the purchase and sale of securities (Securities Act of 1934) following the loss of confidence in the stock market in 1929.¹⁶ The 1934 Act also established the Securities and Exchange Commission, a regulatory agency charged with legal enforcement of capital market regulation. The SEC obtained regulatory control over the securities laws due to Roosevelt's compromise with Wall Street. Macey argues that the removal of authority from the Federal Trade Commission to the SEC overwhelmingly benefited Wall Street interests in that the narrower objectives of the SEC made it more likely that it could be 'captured' by its constituencies.¹⁷

The main target of the legislation was market 'manipulation.'¹⁸ An imprecise concept, defining its scope involved significant economic and political issues, and affected numerous vested interests.¹⁹ The legislation of 1933-4 included several specific provisions outlawing particular practices. Thus, section 16(a) of the 1934 Act required corporate executives to register their holdings of the company's stock, while section 16(b) introduced the 'insider's short-swing profit rule' requiring such insiders to disgorge to the company any profits from trading in its securities within a period of six months. The section

¹⁶ Securities Exchange Act of 1934, ch. 404, 48 Stat. 881 (codified as amended at 15 U.S.C. sects. 8a-7811 (1988 & Supp. I 1989).

¹⁷ Jonathan R. Macey, 'Administrative Agency Obsolescence and Interest Group Formation: A Case Study of the SEC at Sixty,' *Cardozo Law Review* vol. 15, no. 4, 1994, p. 909, 925.

¹⁸ 15 U.S.C. sect. 78(b)(4) (1988). Congress proscribed certain practices, such as the trade in a security 'for the purpose of inducing the purchase or sale of such security by others.' 15 U.S.C. sect. 78i(a)(2).

¹⁹ See generally, Stephen Craig Pirrong, 'The Self-regulation of Commodity Exchanges: The case of market manipulation,' *Journal of Law and Economics* vol. 38, 1995, pp. 144-8; Daniel Fischel and David Ross, 'Should the law prohibit "Manipulation" of financial markets?,' *Harvard Law Review* vol. 105, 1991, pp. 504-5.

16(b) rule was very narrow and easily avoided, since it did not cover trading in shares of related companies, nor tipping, nor 'stringing out' trades beyond the six month limit.²⁰ In addition to such relatively specific rules, the 1934 Act also included a sweeping antifraud provision. Section 10(b) made it unlawful, in connection with any sale or purchase of securities, to 'use any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe.'

In the face of the inadequacies of narrow anti-fraud rules such as section 16(b) and s.17(a), the SEC in 1942 approved regulations under the broad powers of section 10(b), including Rule 10(b)-5, which later became a key and hotly contested provision. Within the framework of a still very general rule against fraud, Rule 10(b)-5 made it unlawful, 'To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading.'

Initially, this provision was very little used. Overall, the rules and their enforcement merely routinized and normalized the disclosure of holdings by executives, as well as other purchasing of large blocks of shares.²¹ The 1930s New Deal reforms, which involved the delegation of regulation to self-regulatory bodies, including stock exchanges and dealer organizations, served to restore political legitimacy to the markets.

It was only in the 1960s, and based on private actions by shareholders and purchasers, that the issue of concealment of privileged information was brought to the fore. By 1965 there had been an appreciable increase in the number of private actions citing section 10(b)-5: in 1962-4 the number of cases citing Rule 10(b)-5 were over 50 per cent more than those for the two prior decades, 1942-62.²² From the 1950s to the early 1970s the SEC contributed very little in the way of control of insider trading, even though it was clear from empirical studies that there was significant undisclosed trading on insider information, particularly in the context of unannounced merger plans.²³ It is clear that the SEC played little more than a reactive role during this period. The agency had

²⁰ The problem with section 16(b) is that it is a suboptimal regulatory mechanism. The section only allows a shareholder or corporation to enforce the regulation in the form of a derivative action. As a result, the SEC is unable to enforce section 16(b) violations.

²¹ Frank Easterbrook and Daniel Fischel, *The Economic Structure of Corporate Law* (Cambridge, Mass: Harvard University Press, 1991), pp. 277-79.

²² Henry G. Manne, *Insider Trading and the Stock Market* (New York: The Free Press, 1966).

²³ Between 1966 and 1980, the SEC launched only thirty seven actions and, of that number, twenty five were settled. See H. Nejat Seyhun, 'The Effectiveness of Insider Trading Sanctions,' *Journal of Law and Economics* 35, 1992, p. 152.

few incentives to disrupt the benefits to its favoured constituencies by implementing a new set of policies which would upset the relationship among the heterogeneous interests and the SEC. Thus, the SEC would not adjust its policies unless there were political benefits to be captured by politicians in Congress.²⁴

8.3 The Uncertainty over the Disclosure Rule and the Problem of Misappropriation

8.3.1 The Evolution of the Modern Legal Doctrine

Contemporary developments in insider trading law are set out in this section. The US policy history can be divided into two periods: the 1960-1980 era during which the SEC's policies were generally reactive, and the post 1980 policy era in which the Congress and SEC pursued a new regulatory strategy designed to promote the long-term interests of market professionals. The activation of the obligation to disclose by means of civil actions brought by the SEC, as well as major criminal prosecutions by the Department of Justice, began in the late 1970s.²⁵ This resulted from major changes in financial markets. In particular, the opening up of trading in share futures substantially increased the potential value of privileged information, since very little capital outlay was needed to take a position on the possibility of a price movement. Options markets are extremely sensitive to takeover rumours, making them especially attractive to insider trading in the 1980s.²⁶ At the same time, the financial boom, creating much greater competition, led to major institutional changes and the arrival of large numbers of newcomers both as employees and major traders.

These changes destabilized the previous regulatory regime which had been based on understandings among the leaders of the major financial institutions and professional firms. While the vast bulk of cases initiated were resolved by out-of-court settlements, some key actions were litigated to conclusion, exploring the ambiguities and limits of legal rules. The basis for more active

²⁴ See, Barry Weingast, 'The Congressional-bureaucratic system: a principal agent perspective (with application to the SEC),' *Public Choice* vol. 44, 1984, 147, 165-179.

²⁵ The SEC brought fewer than fifty actions in the period between 1949-1977, but seventy-seven cases between 1982 and 1985. The first criminal prosecution was brought in 1980, after which about forty percent of cases were criminal in nature. John Naylor, 'The Use of criminal sanctions by US and UK authorities for insider trading: how can the two systems learn from each other?' *Company Lawyer* vol. 11, 1989, p.83.

²⁶ See, Harvey L. Pitt and Karl A. Groskaufmanis, 'A Tale of Two Instruments: Insider Trading in Non-Equity Securities,' *Business Lawyer* vol. 49, 1993, p. 187, 192-95.

enforcement had been laid in the early 1960s, when William Cary, as Chairman of the SEC, supported the deployment of the 'fiduciary duty' concept to establish an obligation on corporate insiders to 'disclose or abstain' from trading. The SEC's reasoning was that there was a duty to disclose material information obtained by company executives, employees and others, since information is obtained in the course of their work which should be to the benefit of the general public.²⁷ This still left very open the extent of the prohibition on the exploitation of such an informational advantage. While the more specific rules governing disclosure of share ownership and trading by executives might be too narrow and easily avoidable, a broader rule dealing with privileged information could strike at the heart of the quest for informational advantages which provides an important dynamic for the markets.

Despite considerable doctrinal debate and some major litigation during the 1980s, including several landmark Supreme Court cases, there remained a lack of clarity both in the formulation of and in the rationale behind the insider trading rule.²⁸ In *Chiarella v. United States* (1980), the Supreme Court introduced a modern approach to the theory of insider trading. The Court accepted that equal access of information between trading parties could not be the aim. The majority in *Chiarella* determined that a degree of inequality in market information did not constitute fraudulent activity under section 10(b).²⁹

8.3.2 The SEC's 1980s National Enforcement Programme

The transformation of the 1930s regulatory framework had occurred slowly at first but quickened as a result of financial market scandals in the 1960s and the increased competition for rents among the diverse groups of interests within the market. In the 1980s, within the framework of the loose and developing doctrinal rules, the SEC conducted a process of stepped up criminal investigation, litigation, and strategic bargaining with the major Wall Street houses, mediated by the various groups of lawyers involved. The *Chiarella* decision had, however, scaled back the liability of those responsible for inside tip-offs, undermining some of the SEC's regulatory instruments. The upshot of the Supreme Court's decision was that, after *Chiarella*, the SEC's policy instru-

²⁷ See Michael Dooley, 'Enforcement of Insider Trading Restrictions,' *Virginia Law Review* vol. 66, 1980, pp.42-3; Jonathan Macey, 'From Fairness to Contract: The New Direction of Rules Against Insider Trading,' *Hofstra Law Review* vol. 13, 1984, p.19.

²⁸ Pitt and Hardison, 'Games without Frontiers: Trends in the International Response to Insider Trading,' *op. cit.* p. 223.

²⁹ Jonathan R. Macey, 'From Fairness to Contract: New Directions of Rules Against Insider Trading,' *Hofstra Law Review* vol. 19, 1984, pp. 9, 37.

ments were altered reasonably to protect the interests of market professionals and expose insiders to greater monitoring and control.³⁰ However, while the SEC cemented an alliance with market professionals and institutional investors by hardening its line on insider trading, in line with prevailing Congressional and public opinion, the SEC also found ways of satisfying other segments of its heterodox constituency. In particular, the SEC extended its protection of incumbent managers threatened by the 1980s takeover frenzy, which required limiting the benefits that market makers in particular were deriving from the takeover market in corporate equities. Let us look more closely at how this complex situation emerged.

By the mid-1980s, Wall Street was in the middle of an unprecedented merger wave and a raging bull market. Corporate takeover specialists achieved significant premiums by breaking-up the conglomerates formed during the 1960s and 1970s. The crucial development, which transformed the market for corporate control, was the introduction of the high yield ('junk') bonds in 1984. Junk bonds made it possible for smaller financial firms and raiders, previously excluded from the corporate control market, to acquire large corporations.

Distributional conflict in the markets intensified in a number of ways. First, the premium fees that finance houses were charging for their services in control contests created further competition between the traditional investment banks and the new investment companies specializing in asset sales. At the same time, the increased takeover activity led to intensified conflict between, on the one hand, market professionals engaged in arbitrage and, on the other hand, corporate insiders (e.g., incumbent managers of corporations) who were the target of takeover and merger activity.

Under the growing influence of market professionals, Congress and the SEC developed policies of increased monitoring and enforcement. The effects of this institutional change yielded both symbolic and net regulatory benefits to market professionals, securities analysts, and institutional investors.³¹ The SEC's successes in prosecuting insiders who violated the securities laws was instrumental in establishing a new and stable regulatory regime based on greater bureaucratization and juridification: the 'increasing codification of rules, a more prominent role for formally constituted organizations, both public and private; and growing penetration of law into the regulatory system'.³²

³⁰ David D. Haddock and Jonathan R. Macey, 'Regulation on Demand: A Private Interest Model with Application to Insider Trading Regulation,' *J. Law and Economics* vol. 30, 1987, p. 311, 316-17.

³¹ H. Seyhun, 'The Effectiveness of Insider Trading Sanctions,' *Journal of Law and Economics* vol. 35, 1992, p. 149.

³² Michael Moran, *The Politics of the Financial Services Industry* (London: MacMillan,

Thus, in gaps left by the indeterminacy of the general rules against insider trading were inserted detailed codes of practice, patrolled by corporate compliance officers, who cultivated a close relationship with the official regulators. Naturally, the prime task of compliance officers is to ensure that no harm comes to the institutions, and to minimize the number of individuals who may have to be sacrificed. The major financial institutions and market professionals in general terms have an interest in safeguarding their investments in more regularized processes of access to unique information, and in discrediting the more unorthodox channels used by a certain group of 'insiders.' The regulations now gave them an additional incentive for compliance officers to turn in their own offenders.

However, the SEC was not only sensitive to the demands of market professionals and institutional investors. The agency manipulated the new regime to cater to a section of its corporate management constituency. These were all potential 'insiders' targeted by the new regime, but their main worry had become the takeover surge caused by corporate raiders (likewise 'insiders') and the new Wall Street players. The SEC therefore also acted to increase the cost of the takeover activities of these new maverick dealers, thus separating the new firms from the Wall Street establishment and constraining a significant element of the favoured market professionals constituency. Ostensibly in order to overcome the enforcement problem exposed by *Chiarella*, the SEC adopted Rule 14e-3, which imposes a duty to disclose or abstain from trading on any person obtaining inside information about a corporate tender offer. This rule was in fact designed to shield incumbent managers who were threatened by takeover bids and subsequent job loss. It did this by creating a cost barrier for corporate raiders and prevented their upstart financial intermediaries from using inside information to encourage takeover activity. Rule 14e-3 was therefore an effective tool in limiting the challenge to corporate insiders from market professionals, particularly those of the latter involved in the heating up the takeover market.

In this way the SEC, despite Congressional intent to support market professionals, continued to respond to multi-interest group demands for regulation. This suggests that there will be collusion between the national regulator and its heterogeneous constituency, and the subtleties of the supply-side of regulation are important for understanding the nature of the legal regime. Using its informational advantage over Congress, the regulator pursued a course of conduct which supported the diverse interest groups associated with the agency in the sense that it succeeded in shielding select corporate insiders from further challenges by market professionals, despite clearly revealed inefficiencies of

the new regime in controlling insider trading.³³

8.4 The Internationalization of Financial Markets and the Emergence of Co-operation in the Regulation of Insider Trading

8.4.1 The Internationalization of Capital Markets

So far we have discussed the legal regulation of insider trading in relation to its purpose and to the distributional consequences of the regulatory process. In the public choice model, we found that regulators were inclined to respond to producer groups which have achieved a dominant position in the political market for influence. In this section, we examine how the internationalization of capital markets poses fundamental problems for national regulators like the SEC. There are strong domestic pressures on them to pursue national regulatory policy preferences in an increasingly international market. The problem regulators face is that unilateral policies, because of their distributional consequences, will prove ineffectual in the context of the international market. Market actors adversely affected by unilateral policies can alter the location of their trades, all of which necessitates co-operation among regulators. The main question is whether national governments can achieve their domestic aims when the distributional benefits of international co-operation are unequally spread. In this section, I shall examine the essential features of the recent transformations of international capital markets, the relationship between market changes and market participants, and how the existence of a partially integrated international market alters the ability of governments to pursue domestic policy goals concerning insider trading.

A review of market practices in the 1980s shows that deregulation and the increased competition of market participants for market share were the factors primarily responsible for the changed institutional environment of national capital markets. In my view, these factors were an incentive for firms to introduce a range of new financial products, which created a new level of risk in the market. These products depended on technical innovations which actually avoided regulation and obtained greater cost savings for consumers. To be sure, the rapid diffusion of these techniques was built on the successes of the futures markets, which were established in the 1970s.

A potential increase in market share stimulated Wall Street firms develop

³³ Seyhun, *op cit.* at p. 149, notes that in the post-*Chiarella* period, the SEC increased enforcement and increased sanctions. Ironically, this study goes on to demonstrate that despite the increased enforcement and sanctions by the SEC, there was actually increased volume in insider trading during the 1980s.

these new 'derivative' products. Given the high volatility of exchange rates, interest rates and commodity rates, corporations demanded new financial contracts to manage the new level of risk in the firm. Short-term and long-term instruments were used by management to attenuate independent shocks. In turn, the new financial contracts were more sensitive to current cost conditions and offered corporations and investors alike a low cost means to hedge against increased volatility. Unlike conventional debt instruments, the new financial products first made it possible to unbundle and reallocate the risk away from investors to parties better able to bear the risk. Secondly, under certain conditions, the new instruments also permitted managers to manipulate the firm's income stream and the flow of the residual gains to investors. We can easily distinguish these two forms of behaviour. What should be clear is that the new pattern of market practice, reflected by the emergence of swaps, exchange traded options, stock market futures and other hybrid debt instruments, stepped up the competition among financial intermediaries, and eroded the traditional role of banks as suppliers of finance for large corporations.³⁴

The growth of the Eurobond transactions is yet another example of a securities market eroding the position of banks as lenders to corporations.³⁵ The international markets for debt and equity expanded several fold during the 1980s. Their importance can be measured in terms of the significant growth of new issuances.³⁶ In addition to the emergence of international securities markets, there has been a substantial increase in cross border trade in equities. Since the beginning of the 1990s, cross border trade has constituted ten percent or more of all equity trading in Europe.³⁷ Most studies suggest that the international integration of markets is likely to continue apace well into the next century. Already, many large exchanges have already entered into agreements in which an overseas exchange is permitted to trade futures, options and other securities within its borders. These inter-market linkages have introduced a

³⁴ Despite loss in market share, banks have continued to play a significant role in the loan market and have increasingly encroached on the domain of securities firms.

³⁵ Colin Mayer and Xavier Vives, 'Introduction,' in Mayer and Vives, (eds.), *Capital Markets and Financial Intermediation* (Cambridge: Cambridge University Press, 1993) p. 7.

³⁶ For example, the global bond market, between 1980 and 1986, increased several fold, from \$38.3 billion to \$225.4 billion. Charles Baltic, 'The Next Step in Insider Trading Regulation: International Cooperative Efforts in the Global Securities Market,' *Law and Policy in International Business* vol. 23, p. 167, 169-170 (1991-2). In terms of US securities purchased and sold from abroad, the volume increased from \$25.6 billion, in 1977, to \$481.9 billion in 1987. Harvey L. Pitt and David B. Hardison, 'Games without Frontiers: Trends in the International Response to Insider Trading,' *op cit.* at p. 202 n.14.

³⁷ William D. Coleman and Geoffrey R.D. Underhill, 'Globalization and the regulation of securities markets,' *Journal of European Public Policy* vol. 2, no. 3., 1995, p. 488, 495.

new level of competition among the exchanges which could result in further restructuring of the industry.

Another indication of globalization can be found if we look at firm level activity. Note that an increasing number of American, European and Japanese investment firms now trade in both emerging and established international markets. In order to produce higher returns to shareholders, American firms, since the 1980s, have expanded into European and Asian markets in order to service their clients and expand their market share. Such large firms as Merrill Lynch and Goldman Sachs have participated in the waves of privatizations of state companies in England, Eastern Europe, and South America which stimulated the deepening of the globalization of securities markets.

Accompanying the internationalization of the world's capital markets has been the increase in concentrated institutional ownership. Concentrated shareholding by institutional investors is a significant factor in the transformation of the large equity markets.³⁸ When institutional investors made significant investments in financial information gathering and monitoring, combined with the development of a network of monitoring by fund managers, the institutional investor community obtained increased leverage against corporate managers and boards. Institutions constitute the largest segment of share trading in Europe and the United States. These shareholders are increasingly demanding transparent markets and stricter enforcement of insider trading regulation. This chapter will now argue that the persistence of an uneven international playing field emphasizes most regulators' preference for domestic interests as opposed to global need, and the ability of politicians to insulate themselves from global influences.

8.4.2 The Regulation of International Securities Markets

The globalization of securities markets and economic interdependence has therefore introduced a new level of complexity which has made it increasingly difficult for national regulators to pursue traditional forms of regulation based on unilateral policies. Governments have looked to a range of co-operative alternatives to pursue their objectives. In this section, first I review the SEC's movement away from a unilateral strategy to a co-operative approach based on the bi-lateral treaty mechanism. Second, I argue that a networked system of bi-lateral treaties gives us instructive example of institutional agenda-setting. I question whether the bureaucratic-professional structure is adequate to

³⁸ William W. Bratton and Joseph McCahery, 'Regulatory Competition, Regulatory Capture, and Corporate Self-Regulation,' *North Carolina Law Review* vol 73, no. 5 (June 1995) p. 1903-25.

articulate a new set of international regulatory standards on insider trading.

Until the mid-1980s, the SEC followed a unilateral strategy of pursuing its domestic regulatory interests. Despite the considerable resources dedicated to the enforcement of international insider trading cases, this strategy failed for several reasons. First, very few countries had a history of regulating insider trading violations and trading could migrate to those jurisdictions. Other things being equal, the SEC found it difficult to rely on its national securities framework to force other governments less dependent upon capital markets, to alter their policy preferences. That fact is that these governments had very little to gain by developing new institutional arrangements which might have a distributional impact on domestic interest groups. Thus, not only was the SEC in a very weak bargaining position, it seems that the only thing left for it to do was to attempt to influence those governments already committed to similar standards to sign treaties or pressurize smaller states into agreements. These considerations, along with increased pressure from domestic groups to get results, led the SEC to abandon its unilateral efforts to extend US jurisdiction and securities laws to other national jurisdictions.

The next step involved an attempt by the SEC to build a broader policy coalition by negotiating a wide range of bi-lateral treaties with national regulatory agencies. As with its earlier unilateral approach, the SEC formulated its international strategy based on the constellation of domestic interest groups (i.e., market professionals and institutional investors) concerned to ensure fairness and accuracy in capital markets. The SEC followed a two-prong strategy. First, it invested considerable agency resources in the monitoring, investigation, and prosecution of insider trading cases perpetrated by off-shore (particularly foreign) traders in US securities listed on American exchanges. While the SEC achieved some gains, it continued to be frustrated in its enforcement efforts.³⁹ Second, the agency sought information sharing and regulatory co-operation through the use of Memorandum of Understanding (MOU) and other law enforcement treaties, e.g., mutual assistance treaties.⁴⁰

³⁹ Extension of US jurisdiction and foreign discovery rules was unsuccessful, but notwithstanding the problem of sovereignty there was further complexity. Regulatory co-operation has its own distributional costs and benefits as foreign regulators have their own vested interests and contrasting systems of control.

⁴⁰ Unsurprisingly, the attempts by national securities regulators to design a co-operative policy-making mechanism have occurred only recently. Coleman and Underhill explain that it was the combination of industry group pressures and the regulatory deficits of national regulators which led to the formation of the International Organization of Securities Commissions (IOSCO) in 1984. See Coleman and Underhill, 'Globalization, Regionalization, and the regulation of Securities Markets, op. cit. p. 504, and chapter one in this volume. In regards to the insider trading issue, IOSCO's Technical Committee has endorsed

The MOU is a bilateral treaty designed to provide extra-jurisdictional information related to market oversight and prosecution (see also chapter one in this volume, section on IOSCO). The bilateral treaty mechanism is a crucial component in the SEC's strategy for limited harmonization of the regulation of international securities markets. Policy pushed through treaties is attractive to the SEC because it creates a reasonably effective structure of bureaucratic-administrative bargaining and negotiation without requiring legislative changes on the part of foreign agencies. While the bilateral treaty mechanism was slow to gain influence, the SEC was later to achieve, in the late 1980s and early 1990s, considerable success in developing a network of relationships among national administrators. In fact the success of the MOU, along with other interests, led the SEC in 1989 to propose a resolution encouraging the International Organization of Securities Commissions ('IOSCO') members to promote information sharing through the negotiation of MOUs. The Technical Committee of IOSCO adopted the MOU process.⁴¹ Porter has argued that the MOU can be viewed as a success if we look to its importance in developing a set of harmonized principles within IOSCO in modifying certain national government's securities regulations.⁴²

Much current public policy analysis understands bi-lateral bargaining (or coordination) as the most basic alternative to a unilateral policy approach. Coordination problems are seen as relatively easy to resolve. However, it is difficult to understand the emergence of more thorough-going *co-operation* without reference to the distributional considerations associated with a negotiated agreement. Conflicts over the distribution of costs and benefits between the parties themselves, as well as in relation to their constituencies, usually determines whether an agreement will be reached. It should be clear from these brief remarks that the main problem for the SEC was how to induce foreign regulators to act in accordance with the US interest concerning fairness to traders generally and price accuracy in capital markets. In order for a co-operative agreement to be effective there must emerge a set of shared regulatory norms and standards which provide the basis for forming expectations in the market. Norms are understood to be effective in that they limit self-interested behaviour.

It is not obvious that a system of bi-lateral agreements, even institutionalized through IOSCO, could alone provide an adequate basis for producing binding international norms, particularly where there are powerful groups with differ-

the SEC's strategy of IOSCO members executing information sharing arrangements.

⁴¹ Tony Porter, *States, Markets and Regimes in Global Finance* (New York: St. Martin's Press, 1993) p. 114-5.

⁴² *Ibid.*, p. 116.

ent preferences. That is, it is not safe to assume co-operation will emerge unless norms are agreed upon in advance. But, it is difficult for these norms to emerge unless there exist high powered incentives or other commitment mechanisms to deter the potential opportunist. A multilateral organization like IOSCO could promote co-operation among its members. However we must be realistic about the capacity of multilateral organizations to create public goods for their members. This is not to deny the possibility that the organization may help define policy-makers' preferences at the national level of regulatory policy-making process. The communicative attributes of these international organizations could hold some value, to the extent that they can pool information which can be used to help open up the regulatory agenda.

There are other, more basic questions which arise regarding the limits of the MOU approach. The SEC is limited in that its extra-jurisdictional investigations are structured and controlled by regulations which emerge out of the contrasting legal and cultural context of the other signatory party. A second problem concerns whether national governments which have only recently passed insider trading legislation actually possess the legal and regulatory machinery necessary to monitor and regulate complex international trading violations. Thus, while we should expect the SEC to continue to pursue its MOU policy, one cannot expect this arrangement to offer an adequate basis for establishing a set of coherent international securities standards unless the constellation of industry interests are carefully balanced in the decision-making process.

At any rate, this discussion illustrates that bi-lateral agreements constitute but one limited form of policy coordination. Given that coordination can be redistributive, it matters which mechanism of coordination is selected. This suggests that any attempt to achieve coordination depends on a set of institutional arrangements which enhances bargaining, and forces governments to compromise and permits the settling of distributional conflicts amongst the relevant interest groups in the market. We now turn to EU's recent attempt to achieve coordination of policy in a multi-level system, simultaneously explaining how the US concern with insider trading appears to have crossed the Atlantic, facilitating international co-operation.

8.5 The Harmonization of European Insider Trading Regulation and International Co-operation

8.5.1 Recent Institutional Changes within European Financial Markets

In this section, I look at the impact of internationally-driven changes in the capital markets on European financial markets, and at the distributional impact of the policy changes emanating from the EU. I will also discuss the general features of the new Directive on insider trading in the EU and the consequences it is likely to have on market players. EU developments have facilitated co-operation with the US, but I conclude that the emerging set of apparently harmonized international insider trading standards may not effectively transform the different national regulatory arrangements unless there is effective enforcement of the EU minimum standards. Given the incomplete system of national enforcement, there is a risk that certain national interest groups may prefer and obtain a different level of regulatory control through lax enforcement. It is not surprising that the effective harmonization of national standards, as with other forms of international co-operation, requires a high degree of collaboration among states in order to achieve equivalent regulatory outcomes. We must remind ourselves that because successful policy harmonization limits negative externalities, domestic interests must place pressure on their governments if they are to capture the benefit and avoid the regressive opportunism of other governments.

European markets are not as competitive as US and UK stock markets. In large part, European equity markets are undercapitalized compared with the US market. What explains the difference between the US and other countries? Some authors, such as Allen, have observed that companies raise a higher proportion of funds in the debt and equity markets in the US.⁴³ Another reason for the difference is that European banks provide substantial direct finance to corporations. In a bank-dominated system, intermediaries typically develop long-term institutional lending strategies. In Germany, for example, large banks have significant influence on the largest corporations.⁴⁴ The reason for this difference may be historical. That is, German banks in the 19th century supplied the much-needed long term capital to German firms. The relationship-oriented system leaves the monitoring and control functions to the

⁴³ See, Franklin Allen, 'Stock Markets and resource allocation,' in Colin Mayer and Xavier Vives, (eds.) *Capital Markets and financial intermediation* (Cambridge: Cambridge University Press, 1993) p. 83 (citing A. Frankel and J. Montgomery, 'Financial Structure: an international perspective,' *Brookings Papers on Economic Activity* (1991) p. 257-310).

⁴⁴ Theodor Baums, 'Banks and Corporate Control in Germany,' in J. McCahery et al. (eds.), *Corporate Control and Accountability*, (Oxford: Clarendon Press, 1993) pp. 267-87.

banks and other large shareholders. It has been argued that German banks have been instrumental in enhancing industry cartelization.⁴⁵ As a consequence, northern European countries, committed to this approach to investment and finance, do not rely on the equity market to raise capital or to discipline and control managers. These factors, along with persistence of privately held firms, has meant that European share dealing is less well-developed.

The most basic change brought about by the internationalization of capital markets in Europe has been the entry of new competition into the market. In certain countries, like France, Britain, and now Germany, the barriers to entry have been removed through a series of large scale reforms both at the national and EU level. The demand of corporate clients for greater sources of finance caused European governments to modernize their public and professional authorities and, most crucially, market organizations (i.e., listing procedures, clearance and settlement, etc.). Another related reason which explains the transformations taking place in the European markets concerns the implications of increased competition between finance centres in Europe. National governments understand that there is a competitive imperative to develop their own exchanges or group of exchanges. In a sense, European governments are supporting the interests of those market players which can benefit from the increased competition and the reduction in the level of regulatory costs associated with taxation, disclosure, and other transaction costs. Thus, the policy to remove protectionist legislation, influenced by the changes in the international setting, will continue to influence and structure the socio-economic conditions which increasingly favour a stock market regime as the basis for raising investment capital. Indeed, and crucially for this chapter, to the extent that European companies have turned to the stock market for finance they have been introduced to pressures from foreign investors to produce accurate and timely information and to limit insider trading by corporate insiders.

What is clear is that these reforms have yielded a number of benefits for investors. First, the private and public innovations have increased trading efficiency. For example, the new level of transparency ensures that information is effectively disclosed to investors. This means that the investor, when considering whether to purchase shares, will be able to predict more accurately the future value of the investment based on the information possessed and the observation of share prices. The prospect of a flow of share price information thus enhances the efficiency characteristics of the market for foreign investors. Second, the deregulation of share listing requirements and the introduction of share listings abroad, motivated by the need to obtain greater sources of

⁴⁵ See Alexander Gerschenkron *Economic Backwardness in Historical Perspective* (Cambridge, Mass. Harvard University Press, 1962).

finance, has allowed institutional investors to take advantage of the differences among markets. In contrast, the losers in the competitive struggle have attempted to influence the distributional costs by pressuring national governments to adopt lax domestic standards in the case of insider trading, or to undermine the policy goals of the EU through delays in implementation of the policy changes. Changes in the EU insider trading regime have once again highlighted the role of interest groups and distributional conflict.

8.5.2 The EU Measures against Insider Trading

I will now focus on the EU policy on insider trading. Like the US approach, an important component of the EU reform process is concerned with the protection of investor confidence. Until recently, European equity markets were not been concerned with the principle of fairness between investors. At most, governments considered the practice merely unethical behaviour. This approach resulted in costs. It is thought that the presence of informed insiders contributed to the thin capitalization of these markets and the absence of outside investors from these markets.

Another reason for the underdevelopment of the European equity markets was the strength of banks in supplying investment capital to firms. It is clear that the European bank-oriented strategy of investment, unlike the stock market system, permitted banks and corporate insiders an informational advantage over outsiders when trading in company shares. The right to trade on inside information tended to increase the banks' and corporate insiders' trading returns and leads to opportunism with a negative impact on stock exchange business. Hence, the introduction of insider trading reforms at the European level challenged the broad coalition of interested parties which previously benefited from the old system of regulatory standards. The question arises as to how any insider trading prohibitions became accepted in the first place, let alone rapprochement with the SEC in the US.

The EU's liberalization program is based on a pattern of policy-making with an impact on both domestic and EU level interests. The EU is not a unitary structure but must maintain a multi-level playing field in its single market.⁴⁶ In this respect, the success of further integration depends upon the coordination of policy for the reduction of negative externalities. Early EU efforts to achieve coordination through the imposition of across-the-board harmonization failed because they created unworkable complexities and did not focus on what really mattered to further market integration.⁴⁷ In 1985, the EU recognized

⁴⁶ Fritz W. Scharpf, 'Community and autonomy: multi-level policy-making in the European Union,' *Journal of European Public Policy* vol. 1, no. 2, Autumn 1994 p. 1350.

⁴⁷ See William Bratton, Joseph McCahery, Sol Picciotto, Colin Scott, 'Introduction:

the need to adopt a more efficient process for the achievement of regulatory goals. To this end, the Commission limited its harmonization efforts to the essential minimum requirements, which allowed a high degree of diversity among national rule. The new approach involved the introduction of the principle of mutual recognition, developed by the European Court of Justice in the *Cassis de Dijon* (1979) case, a measure designed to allow member states to maintain its own rules so long as they are substantially equivalent with Community regulation.

It is argued that the EU regulatory process is different from other international organizations in two important respects. The main reason for this claim is the observation that member states effectively pool their national sovereignty through qualified majority voting and delegate their sovereign powers to EU agencies.⁴⁸ The general conclusion is that this complex decision-making process allows for effective (and less costly) decision-making in that introduces a credible mechanism for states to establish institutional compromises. Let us turn to the EU measures designed to regulate insider trading.

The EU enacted the Directive on Insider Trading on 13 November 1989.⁴⁹ The Directive stated that the aim of the regulation was to guarantee investor confidence by ensuring equal market opportunities for all investors. The Council of Ministers passed a unified Directive on the grounds that the harmonized provisions would eliminate conflict between certain countries and provide the basis for co-operation and enhanced enforcement. Like US law, the directive is concerned with the public disclosure of information that would have a significant effect on market-sensitive information.⁵⁰ The Directive is concerned with price accuracy and fairness among traders. The Directive was welcomed by most member states although Germany, due to domestic pressures from the large banks which stood to lose, delayed implementing the EU Directive until mid-1994.⁵¹ Inside information was defined as information

Regulatory Competition and Institutional Evolution,' in William W. Bratton et al. (eds.), *International Regulatory Competition and Coordination* (Clarendon Press, 1996).

⁴⁸ Andrew Moravcsik, 'Preferences and Power in the European Community: A Liberal Intergovernmentalist Approach,' *Journal of Common Market Studies* vol. 31, no. 4, 1993, p. 473, 509.

⁴⁹ Council Directive 89/592 of 13 November 1989 coordinating regulations on insider trading, *Official Journal of the European Communities* (hereafter *OJ*), L 334/30, 1989. For an excellent analysis of the Directive see, Klaus J. Hopt, 'The Insider Dealing Directive,' *Common Market Law Review* vol. 27, 1990, p.51.

⁵⁰ *OJ* L 334/30 1989, Art 1 (1).

⁵¹ Daniel James Standen, 'Insider Trading Reforms Sweep Across Germany: Bracing for Cold Winds of Change,' *Harvard International Law Journal* vol 36, no. 1, Winter 1995, p. 177. Indeed it would appear that the passage of The Federal Securities Trading Act in

which 'has not been made public.' This expression is designed to facilitate the release of information to the public.

An important feature of the Directive is that it ignores the fiduciary relationship between insider and firm and imposes liability on the traders who possess inside information if they fall within one of the definitions provided in Article 2 of the directive. Article 2 distinguishes between primary and secondary insiders. Under the Directive, a primary insider includes corporate insiders who obtain information by virtue of their position in the firm, as shareholders of the company, and as persons who obtain information 'by virtue of the exercise of his employment, profession or duties.'⁵² Interestingly, based on this clause, it would also appear that an employee could be treated as an insider if he/she comes in contact with the information through the employment relationship. This clause is interesting because it provides that nonconventional insiders, such as the printer in *Chiarella*, would be liable by virtue of obtaining inside information in the exercise of their employment.⁵³

The Directive also provides that secondary insiders, i.e., those who receive a tip-off, are prohibited from trading on inside information. Secondary insiders obtain information from the primary insider ('tipper'). The Directive does not require that the 'tippee' obtain the information through the course of employment. Despite the difference between primary and secondary insiders, it is clear that both classes are restricted from the use of non-public information in the purchase or sale of transferable securities. The Directive further provides that the information must be specific (i.e., it must be price sensitive). Like US law, insiders are liable only if they were aware of what they were doing at the time.

Primary insiders are also subject to a 'tipping prohibition.' That is Article 3 states that insiders are prohibited from disclosing insider information to third parties. It further provides that insiders shall not recommend stocks that could make a profit or acquire shares for the benefit of third parties based on inside information. However, it seems that the Directive permits the practical handling of inside information between market professionals and their clients. In article 4 of the Directive, 'tippees' are not treated the same way as primary insiders. That is, tippees are not permitted to trade based on inside information but they are allowed to pass on information.⁵⁴ This section of the Directive

Germany, in 1994, has so far done little to alter the trading practices of insiders. Financial Times, *Financial Regulation Report* December 1995, p. 22-3.

⁵² OJ, L 334/30 1989, Art 2(3).

⁵³ Paul L. Davies, 'The European Community's Directive on Insider Dealing: From Company Law to Securities Markets Regulation?' *Oxford Journal of Legal Studies* vol. 11, no. 1, 1991, p. 92, 102.

⁵⁴ See Klaus Hopt, 'The European Insider Dealing Directive, op. cit. p. 70-2.

is thought to be incoherent.

While the EU monitors the implementation of Directives into national law, Directives are primarily enforced by the member states. Member states make regulatory decisions within their different institutional frameworks.⁵⁵ Article 8 of the Directive states that member states are required to identify the regulatory agency designed to perform the task of enforcement and provide this body with the resources necessary to ensure the proper exercise of their functions. This institutional design could lead to lax enforcement particularly where the governments have an incentive to minimize the goals of the Directive. In order for this kind of decentralized enforcement to be effective it depends on transparency of other member states' regulations and the effects of those policies. The lack of transparency and substantially equivalent sanctions could undermine the necessary level of trust required for the mutual recognition framework to function effectively. I would argue that the mutual recognition approach to co-operative regulatory control is unlikely to be effective unless member states pursue similar policy interests.

If the approach is to be effective, then the respective domestic constellation of interests in member states must develop shared norms and convergent policy preferences. There is little evidence of such developments at present, as illustrated by the slow pace of market reform in a number of EU countries. Indeed, a large number of member states have so far failed to comply with other securities directives, such as the Investment Services Directive, emanating from the EU, let alone establish the expertise in agencies capable of monitoring and enforcing insider trading practices in complex securities and securities-related markets. Very differential levels of enforcement are likely to prevail, conveniently alleviating the distributional conflict among domestic interest groups in their respective markets.⁵⁶

Of course this makes it even less likely that there will be a successful convergence of EU and US norms on insider trading. Domestic dynamics,

⁵⁵ In view of the discretion left in Article 8 to member states in designating the administrative authority or authorities competent and determining the appropriate penalties (Article 10), these provisions are clearly not directly effective, hence ruling out the kind of decentralized enforcement made possible by direct reliance on EU Directives in national legal proceedings. See Deidre Curtin, 'Directives—the Effectiveness of Judicial Protection of Individual Rights,' *Common Market Law Review* vol. 27, 1990, p. 708.

⁵⁶ It should be noted, however, that the European Court of Justice, in *Von Colson and Kamann v. Land Nordrhein-Westfalen* [1984] ECR 1891, held that even in cases where member states appeared to enjoy considerable discretion in the choice of sanctions in cases of non-compliance, as a minimum standard the sanctions should be effective as a deterrent. Nonetheless, it will take time before legal challenges bring about effective harmonisation of enforcement standards.

despite globalization, still have a prevailing impact on insider trading regimes. Long run convergences cannot be ruled out, but that will require the effective resolution of distributional conflict in national regulatory contexts. What is likely in the medium term at least is the continuation of *apparent* convergence around US style norms, but the prevalence of highly differentiated enforcement standards among EU member states and between them and the US, reflecting the contrasting nature of interest group competition among competing jurisdictions.

8.6 Conclusion

The basic objective of this article has been to explore the role of domestic pressure groups in the dynamic process of insider trading regulation in the USA and Europe. I have attempted to integrate public choice theory with a historically informed analysis of the social-institutional setting of insider trading regulation. I have focused on the conflicts between market professionals and corporate insiders and shown how regulators preferences will be shaped by both supply side and demand side considerations of the regulatory equation. This suggests that the dynamics of regulation depend on the strategic relationship between regulated interest groups, the national regulator, and political incumbents. Intensified competition for economic and regulatory rents often leads to doctrinal indeterminacy in defining regulatory norms. In the European context, which is underdeveloped, we noted that the potential benefits from increasing insider trading regulation may be discounted through lax enforcement. Given the intense and ongoing transformation in these national markets, we can expect that the level of regulatory enforcement of insider trading will be uneven. This will fuel ongoing conflict with US authorities despite the apparent convergence of legislation.

CHAPTER 9

MODERNIST AND POSTMODERNIST PERSPECTIVES ON PUBLIC LAW IN BRITISH CRITICAL LEGAL STUDIES*

What does it mean to be 'critical' today? Inevitably the question of perspective confronts every post-Enlightenment legal theorist attempting to offer a critical vision of the legal system and its operations. Indeed, this concern is reflected in the attitudes and practices of virtually all theorists working in legal theory for the past fifteen years. Not surprisingly the question of theory choice has had significant implications for theorists working within the radical legal tradition in the United Kingdom and the United States of America and is responsible for the disagreement and differences in theory and the way it is practiced. The discord and conflict over understanding and representing the law is the result of real intellectual disagreement as well as a cognitive misunderstanding (Schlag 1989: 1208).¹

* This chapter appeared in 2 *Social and Legal Studies* (1993).

¹ Pierre Schlag complains that legal theorists are constantly misunderstanding one another. It happens all the time. Dworkin's attack on American critical legal studies is an example. Schlag thinks there are all sorts of misunderstandings that occur from different perspectives. What is so frustrating is that we live in many different cognitive frameworks and we move between them all the time. Schlag's point is that there is no common ground of discourse. I am in agreement with Schlag that 'our' discussion of different discourses should not rely on the epistemic truth of each perspective. My disagreement with Schlag, however, concerns his claims of non-comparability of legal discourses. In the main, his argument depends on positing the existence of distinct cognitive frameworks (a rationalist move) and then he denies their unity and coherence (a modernist view) in order to sustain his claim that there is both incommensurability of the cognitive frameworks and a progression among these frameworks (a postmodern position). I find this argument clever and suggestive but not convincing. To hold that cognitive frameworks are incommensurate and, at the same time, argue that there is progression in understanding the incommensurability is a species of rhetoric rather than logic. Schlag (1989: 1250) thinks that this sort of objection is only a problem for rationalists. I find Schlag's argument unconvincing particularly since theories are comparable if we employ referential semantics to determine the truth content of a statement (Devitt 1991: 168-172). Finally, Schlag's argument that there is an understanding of

Theorists working within the critical legal studies (cls) tradition in Britain have looked to either a modernist and postmodernist vision in order to develop a critical account of the juridical subject, the regulatory state, rights, and democracy. The hallmark of a 'critical' perspective involves a challenge to the philosophical tradition of the Enlightenment, and the liberal legal order which is supported and sustained by Enlightenment convictions, particularly its view of rationality and human nature. Critically-minded theorists are troubled by the optimistic vision of the Enlightenment. They show that its progressive tendencies have been undercut by its underside which has left liberal society without philosophical and cultural reserves and a culture characterized by self-destructiveness. Unwilling to reconstruct the optimistic vision of Enlightenment reason, modernists and postmodernists alike have substituted the language of Enlightenment concepts with a new set of references and assumptions regarding rationality and the social system. The importance of this shift can not be underestimated since it is common to the aspirations of the legal theorists working on both the modernist and postmodernist sides of the street.

The reaction to liberal society and its rationality has been the formative influence in the production of legal theory in the 1980s in Britain. Most, if not all, of the theory produced depended on the assimilation of vocabularies which owned their self-descriptions to either a critical perspective which accepts the importance of democratic deliberation in creating legitimate institutions or on discourses which decenters ego-centered reason and demonstrates that democratic institutions are the products of power.

The modernist response to liberalism and the Enlightenment tradition takes the Frankfurt School and Habermas as their starting point. These scholars employ the concept of immanent critique and attempt to offer an internal criticism of law and the reified features of modern society. Immanent critique has ties to Hegelian idealism (Habermas 1984: 366). The theory of society which employs immanent critique looks to the normative conceptions of legitimation, law, publicity, and rights as the resources for a critique of domination. In theory, immanent critique operates to penetrate behind the appearances of a reified social reality so as to reveal, within the existing forms, an emergent set of alternative possibilities which are qualitatively superior to the existing arrangements. On this view, immanent critique is the foundation for a view of law defined as a self-justifying autonomous region of the social which influences

the progression among the cognitive frameworks is unsatisfactory due to its implicit reliance on an epistemic claim which has nothing to do with his semantic claim regarding incommensurability of meaning.

the social, cultural, and political externalities but is uninfluenced by them in the end (Hunt 1987: 12).

The second response takes Nietzsche, Foucault, and Derrida as its sources of inspiration (Murphy 1987; Goodrich 1985). These scholars reject immanent critique and other universalistic concepts of law and jurisprudence as dogmatic and premised on an externalization of theory (Goodrich 1990: 1-2). The postmodernist response announces that 'the Hegelian party is over' (Murphy 1989: 135) and attempts to show that a democratic vision of society, based on the rational properties of the self and rational deliberation, may not be possible. These scholars deny the importance of public freedom insofar as it is manifested within the democratic legitimacy of the state. By attempting to supplement law with discourses that have been kept outside the law, postmodernists are attempting to break apart the closed and formal system of law and challenge the legal theory and practices which sustains it. Postmodernist argue that the Enlightenment's claim to objectivity and rationality masks an authoritarian and totalizing logic. Theorists favoring postmodernism embrace difference, displacement, and the disruption of discourse. Central to the postmodern project is the attempt to deconstruct the democratic tradition of the Enlightenment, and its legal forms, and to show how these institutions conceal domination while appearing to offer a discursive framework for collective regulation of society. On this view, legal and political institutions are bureaucratic structures in which agents have very little control of the pattern, distribution and operation of the institutions. Indeed, it is argued that normative legal discourse itself 'is coextensive with bureaucratic practice and institutional inertia' (Schlag 1990: 186).

In this paper I will claim that the modernist and postmodernist visions are partial and to my mind incapable of describing the complex structures of a modern constitutional democracy. I shall try to show that the modernist response, which challenges the philosophical underpinnings of liberalism, and involves a search for different foundations which ultimately rely on a morality and communication free from domination, is, at best, problematic. That is, I find the modernist idea of convergence too unlikely a basis for founding democratic legitimacy. I will consider the postmodernist claim that the legal system is built on the expression of the democratic will but rather by an absent Other, an absent unity which is a leftover from the Enlightenment. I shall try to show that the postmodernist strategy to decenter the law and eliminating the social is, in my view, is based on an undifferentiated concept of power. The genealogical account of modernity, read through the lens of Nietzsche, leads an understanding of how modern institutions constitute the identities of subjects and shows that norms, institutions and the like are controlled by power but

masked by democratic and liberal claims to freedom and deliberation. I think this view is unduly one-sided in that it while it challenges the democratic institutions which emerged from the 18th century, it ignores the associations and autonomous relations that emerge out of the differentiated sphere of modern civil society.

The theme of this paper is that the content and direction of both modernist and postmodernist critiques involve a theory of society which directly challenges the normative foundations of English law and practice. Part I looks at the Sheffield School's criticism of the traditional view of constitutional law and representative democracy. This vision challenges Dicey's conception of formalism based on precedent and the the broad discretionary power of parliament. I will argue that the recentering of constitutional discourse, which brings in the state, is only partially successful in its challenge of the formalist vision of English consitutionalism. It will be argued that the Sheffield school's reliance on modernist reforms, like public dialogue and deliberation, may not produce greater legitimacy or a more rational government. Part II considers the modernist-inspired challenge to adjudication in the liberal welfare state. The early modernist attacks were heavily influenced by grand critiques of the liberal welfare state (i.e., Unger). These theorists concentrate on legal doctrine and its indeterminacy in order to reveal the imperfect foundations of the decision-making sphere of the welfare state and government's authority generally. This approach is subject to internal tensions and its failure as a fully-explanatory theory has been widely acknowledged. In this section I will also focus on the development of a late modernist critique of state and society which reconstructs the Enlightenment institutions in terms of modern systems theory. Exploring the development of systems theory in English public law, I consider the effectiveness of a theory of political society in which the major institutions are stabilized by communications and the basic norms of authority are irrelevant to its decisions and reproduction. The strength of systems theory is that it may accurately describe some of the current changes in the social and political structures and provide an internal critique of the legal system and its formalist justifications. Part III focuses upon postmodern arguments against the language of democratic participation and the normative foundations of the liberal state. The discussion will include an analysis of the doctrinal and political arguments against the liberal model. The analysis will be directed towards an analysis of Goodrich's recent writings which advocate a non-ethical critique of law that gives priority to showing that law's authority is based on structures belonging to the sacred and a vision of society in which '[I]f life is condemned to expend, to squander itself on the other side, formlessly, subterraneanly and buried from sight as refuse or waste' (Goodrich 1990:175). It will be argued that the postmodern vision of modern political and legal

institutions is overly narrow in that it eliminates the social and neglects the other side of democratic institutions, i.e., associations within civil society. It is argued that these groups serve to channel its normative claims into the political system.

I.

9.1 The Specter of Enlightenment Rationality and the Modernist Response

Rationality, as a species of modern thought, is highly controversial and has generated a significant body of scholarly discourse. The basic assumptions of the rationalist discourse emerged in Europe in the 17th and 18th centuries, and provided the philosophical foundations for the next two centuries of political and legal culture. The Enlightenment culture articulated a vision of a civic project which attempted to deploy the concepts of reason, truth, and knowledge in order to make modern political philosophy more effective in overcoming skepticism. The liberal vision of the Enlightenment was supplemented by a scientific culture which assumed that political institutions might be made more rational if its assumptions could be employed explain the individual's motivations and the workings of democratic institutions (Rapaczynski 1987: 8). In this interpretation, the political philosophical project of the contractarian tradition attempted to derive the rationality of human institutions based on a concept of human rationality. In this respect, the struggle to develop a liberal political tradition is closely associated with positivism in natural science (Hobbes) and a philosophic project of refuting skepticism (Locke) (Shapiro 1990: 44). The Enlightenment project of political philosophy employed an epistemic vision in order to overcome the problem of skepticism and establish liberal institutions based on objectivity. As a result, the Enlightenment project produced a highly ambitious project based on the production of institutions founded on the standpoint of knowledge which is absolutely valid.

The normative ideals of the Enlightenment were crucial role in justifying modern legal and political institutions and supplying a conception of citizenship based on rational agents freedom to choose.

In this respect, liberal theory conceived of human beings as individuals first and then they were constituted as members of governing communities. An individual was thought to be capable of engaging in dialogue and deliberation regarding different goals and values and the rational self is capable of distinguishing between specious and truth claims. Early liberal theory combined the normative standpoint of citizenship with the pure reflective consciousness of

the self. On this view, subject-centered reason was understood as independent of particular groups constituting the political community and particularistic discourses which are subordinated to the cognitive orientations of reason (Bridges 1991: 49). By assigning the subject both cognitive and political authority, the Enlightenment culture of rationalism affirmed ego-centered reason as the locus of truth and reason (Schlag 1989: 1210-1213).

Liberal political institutions are based on the cognitive standpoint of the universal and objective reasoner who was thought capable of offering justifications for those institutions based on logical foundations. The development of liberal political institutions was founded on first principles which reflected a particular cognitive background and vision of public life (Shapiro 1990: 208). The task of justifying political institutions depended on a mode of rational thought and an appeal to the optimistic aspects grounding the Enlightenment project. The essential identifying rhetoric of the Enlightenment political standpoint was its attempt to locate the substantive foundations for political and legal institutions in a universal and neutral form of reason. Rorty (1979) has shown that there was something amiss about the foundationalist story of the Enlightenment. That is, the foundationalist story was based on an anti-historical account of reason which made it possible to generate consensus on the norms guiding and justifying liberal political institutions.

The cogency of the Enlightenment vision is challenged by modernists who find the cognitive discourse of liberalism unpersuasive. Essential to this view is the proposition that the construction of freedom and choice are the products of historical communities and not abstract reasoning processes of disembodied agents. The Enlightenment project was committed to the individual and the notion of community and social relations were irrelevant to the rhetoric of justification. The modernist culture which replaced Enlightenment rationalism is based on a socialized individual which is the product of a particular historical tradition and community of judgment. In this regard, the individual is the product of social relations and emerges from different backgrounds, distinguished by class, ethnic, gender, and religious orientations. As a result, preferences are adaptive and reflect changing institutional structures, consumption patterns, information availability, and social and cultural constraints. In short, individuals are shaped and structured by the norms and customs of a particular community (or sets of overlapping communities) and their identities are contingent (Rorty 1989:23-43).

This vision of the subject challenges the rationalist view that individuals are free and equal citizens and make free choices regarding the form and content of legal rules based on neutral and universal values. The modernist argues that

there is an important relationship between the identities of subjects and the social structures of diverse ethnic, religious and class-based communities. Modernists reject the rationalist view that there is a divide between particularist communities and the political institutions of democracy. They also reject the divide between individual and social structure, and insist that there is no external, objective standpoint to support the liberal ideals of freedom and autonomous reason (Schlag 1989: 1216). Modernists reject the vision of a neutral, liberal state grounded by the norms of the Enlightenment. We shall now turn to examine and assess a current of modernist thought as it is expressed in the context of English public law.

9.2 Modernism and Public Law: 'Critical Public Law'

The analysis within this section will be structured in the following manner. First, we shall examine the modernist critique of the public law framework developed by Tony Prosser. This inquiry will be divided into two parts. In the first part, we will discuss the role of the state and its importance for challenging the formalist conception of public law. There will also be a discussion of Prosser's broader criticisms of public law and his endorsement of Habermas' theory of communicative action as a basis for a redefined public tradition. In the second part, the cogency of Prosser's proposal will be considered.

The modernist picture of public law, as developed in England by the Tony Prosser and the Sheffield School of public law, attempts to offer a theory of political legitimation based on the potential moral content of the properties of positive law. Following the insights of the Frankfurt School, particularly the early work of Habermas, the Sheffield theorists employ an immanent critique as a method of subjecting rival theories to internal criticism by employing their own substantive criteria as a means to reveal errors, aporia, and conceptual errors in reasoning. By exposing rival theories to a review of their own conditions of production, the Sheffield theorists show that the limitations of a particular theory and offer, as well, a normative basis for transcending the theory. The emphasis on an appearance versus reality framework supports the view that the concept of critique can assist the task of constructing an alternative theory, which could pave the way for a qualitatively superior social arrangement. By resorting to a theory of communicative rationality, the Sheffield School impliedly assume that new, more coherent, normative structures will emerge.

Prosser in the early 1980s offered a programmatic statement sketching out a theory of public law which accounts both for the state's actions and offers a normative perspective by which to evaluate the actions of the state. In analyz-

ing the tradition of English public law, Prosser (1982) points to the noticeable absence of the state in the empiricists' planning model. Prosser's objective is to draw in the state. Prosser rightly argues that the positivist conception of law is linked to the liberal state which is based on precedent and statute. Due to changes in society, Prosser believes that we have entered a post-liberal era which is characterized by the wide use of discretion by the executive and the proliferation of new forms of governmental-administrative forms. This change is regarded by Prosser to have produced a crisis in public law. The crisis concerns the failure of the traditional constitutional-administrative model to adapt itself to the new forms of state action and regulation without the introduction of fragmentation and indeterminacy at the level of doctrine.

For Prosser, the formalist model of Dicey was insufficiently flexible to address itself to the changed nature of the state. The concept of the interventionist state must be theorized in order for public law theorists to adequately explain the changed nature of state/society relations. This is an important issue now that state action is based on administrative discretion. The problem of discretion introduces us to the problem main problem which concerns the Sheffield School, the problem of public accountability and the legitimacy of state action. The implication is that if there are few rules to serve as a restraint on state action the democratic process will have been usurped by the state which is not accountable to parliament or the public. Graham and Prosser (1991) have attempted to illustrate this point in the context of the privatization process in Britain. They argue that the comparative success of the British government's privatization program is the result of the use of a broad range of legal forms which operate free from judicial review and constitutional supervision. It was the exercise of 'dominium' power which was a crucial factor in the successful disposal of state assets (Craig 1990: 189).

Prosser proceeds to explore in detail the politicization of the state and the legitimation problems that it causes. He explains that the state's two principal functions, legitimation and accumulation, conflict with one another. The increasing penetration of the state within the economy threatens the legitimacy of capitalism in that it substitutes political for market criteria and in the process delegitimizes the state's neutral position vis a vis the market. To say that there is a deficit in legitimacy of state action means that the operations of the state no longer appear to benefit the public interest generally. Prosser offers an alternative version of public law which provides for a new theory based on unconstrained discourse and public accountability. The new critical public law is founded on both a procedural and substantive basis which will secure the implementation of public policy on a legitimate footing.

Prosser readily admits that his proposal is informed by a set of arguments flowing from Habermas' view of a rational society. Habermas' view of legitimation is structured around the moral content and properties of law. For Habermas, the source of legitimation is founded on the idea of impartiality which forms the core of practical reasoning. An important thread running through Habermas' thought is rational consensus which is based on the values of free and unconstrained discussion of reasonable persons. Norms which arise from communication secure the footings of the legal system. Habermas believes that norms are crucial for settling impersonal conflict and realizing political goals. The idea of legitimacy, based on legality, is established on by the claim that morality is core of positive law. Such a conception of law is based on the view that moral argumentation has been internalized within the legal process. A crucial further point is the proposition that political institutions can become accountable and operate with the principles of political legitimacy only if there is active citizen participation and information is public and widely available. A reformulated public law, based on the critical force of communicative competence, is the theoretical framework for a critical public law. Prosser's shift to a critical public law is founded on a modernist approach to law. The concept of rational communication provides, as we have seen, the central methodology for achieving legal rationality in a change world of highly interventionistic state action. It is used to justify both the principle of democratic accountability, as a basis for state action, and the principle that norms ground legitimacy. There are problems with the conception of public law that emerges.

The first is that the concept of society and politics offered by Prosser, and Habermas, is based on a concept of subjectivity which is problematic. The hallmark of Habermas' concept of (inter-subjectivity is based on the view that the actual exchange of views between agents can lead to a rational consensus and a claim to universalization if an actual agreement occurred. A fundamental aspect of Habermas' view is argument that speakers possess the ability to distinguish a valid claim in the context of a conversation in which the force of the claim will be accepted by reference to the ground and support given to arguments. For Habermas, the neutral procedure is said to draw upon the values of general practical reasoning. Habermas' communicative structure looks to the universality of truth claims which provides criteria for evaluating cognitive claims. Habermas' theory of democratic legitimacy provides an objective and rational basis which attempts to link together positive law and social norms.

A fundamental axiom of this concept of politics is the claim that public discourse will create a rational foundation underlying political and legal institu-

tions. The weakness of this view of politics has been expressed by Elster (1983: 42) who states that 'one cannot assume that one will get closer to the good society by acting as if one had already arrived'. The cooperative public search for consensus may not produce consensus however. Indeed, it may be that there are circumstances where 'arguments cannot be stated publicly in a public setting' (Elster 1983:35). Or, even if people are confronted with the truth, they may not be in a symmetrical position and therefore will be unable to locate a compromise. There may, in fact, be situations in which there is no compromise to be had. The theory of communicative action depends on the principle that discourse is carried out with rational subjects offering a full exchange of information. It is often the case that the disclosure of information is partial and linked to an agent's specific interest.

It may be that rational deliberation involving the channeling of information between the parties may not produce greater legitimacy. Parties may prefer to be less informed (Fitts 1990: 920). Less information may even lead to more efficient outcomes. Under the general conditions of political competition, deliberation may not lead individuals to subordinate their private, subjective preferences to the collective good. Another view is one that suggests the 'deliberation educates preferences and makes them more general: It leads to the broadest agreement at a particular time. But it stops there, leaving conflicts unresolved' (Przeworski 1991: 18). A more realistic view of democratic politics is based on the argument that groups tend to engage in dialogue in order to secure their own political position. This process does not lead naturally to an undistorted exchange of information based on the generalized concern to create some long-term benefits for the public good.

The second difficulty with Prosser's critical public law proposal relates to the attempt to offer a normative theory of legitimation. Prosser endorses Habermas' (1976: 29) view that 'every effective belief in legitimacy is assumed to have an immanent relation to truth ... that can be tested and criticized'. This particular theory of legitimation is based on the claim that the substantive aspects of legitimacy are drawn from the normative structures located in civil society. This model assumes that the political and legal institutions are capable of limiting the negative effects of power. Here power relations are defined as strategic and are centralized in juridified structures. Some of the difficulties with this view have been revealed by Foucault who has encouraged us to see that modern society is shaped by diverse power relations which involve techniques (of normalization) that are not limited to the administrative state. Now I do not believe that all power is localized at the micro level, I think that it is less meaningful today to only speak of legitimation based on the juridical system and parliament.

Critical public law is premised on the modernist vision that the debunking ideological claims by reference to truth will be a powerful legitimating force. From a normative standpoint, the argument assumes that individuals are committed to action based on reasons which are true and undistorted. It might be that the requirement of truth is too demanding. That is, we all live in particular communities of judgment which are constituted by speakers who recognize the same norms of daily life. There are many different communities which are 'overlapping' (Rawls 1987). I do not believe that conditions always exist for overlapping communities of judgment to converge on certain norms of agreement. Critical theory's stress on the right outcome is, of course, context-dependent but its emphasis on normative validity as a theory of legitimacy implies that we have a good rationale for believing that conflict and disagreement can be resolved by dialogue. This assumption is distinctly modernist and difficult to accept.

9.3 Immanent Critique, Communication, and the Public Sphere

Other theorists working in the public law tradition also offered an immanent critique of the constitutional-administrative system based on Frankfurt school social theory. Employing the technique of immanent critique, Harden and Lewis (1986) attempt to demonstrate that, by exposing the weaknesses and salient features of the British constitutional system, they could identify the structural components of a new constitutional system. The development of a reconstructed rule of law, based on democratic deliberation and collective learning, is linked up to the view that public participation will tend to produce a rational and accountable state. The benefits of participation depend on increasing the flow of information to citizens in order for them to educate their participation. Critical evaluation of this model can best proceed by considering the substantive legal reforms, involving administrative review reforms. I will also evaluate Harden and Lewis's arguments for establishing a constitutional system based on communicative rationality.

For Harden and Lewis, the foundation of a reconfigured constitutional-administrative system is based on the introduction of a variety of reforms which operate to force legal decision-makers to consider many different points of view. Harden and Lewis' aim is to introduce a 'hard look' doctrine as a mechanism to promote greater government accountability. The insight here is that the present techniques are not considered responsive to differing interests and a hard look approach will ensure greater informational input and lead to outcomes which are the result of careful consideration of the available alternatives. It is also argued that there should be a general obligation that administrative bodies give reasons for their decisions. In general, Harden and Lewis are

concerned with generating greater access to public participation in government decision-making. The concern for greater accountability through the introduction of structural provisions mentioned above is based on a belief that the pathologies associated with government decision-making will be limited. We may doubt whether the reform of the administrative system is possible given the resources and tradition of public law in the U.S. There is no reason to believe that the existing system, insofar as it offers a substantive test of reasonableness, in the context of the review of agency decision-making, does not employ reasoning similar to the kind employed by courts applying the doctrine in the United States (Craig 1990: 184-187).

At the most basic level, Harden and Lewis attempt to employ immanent critique to dislodge Dicey's positivist vision of public law from the English constitutional imagination. It is hoped that the demystification of formalism will expose the classic weakness of British constitutional politics. In the main, Harden and Lewis argue that Dicey's conception of the constitutional framework has failed to produce satisfactory decision-making or public accountability over those decisions. In an apparent attempt to reverse and restore the fortunes of the British constitutional tradition, they offer a theory of constitutionalism which is premised on a rational political morality tied to an ideal constitution. The belief in a reformed constitution anticipates greater responsibility for the courts in ensuring quality control for the legislature.

Like Prosser, Harden and Lewis contend that increased governmental effectiveness is related to the introduction of constitutional procedures which enhance public participation and provides for greater range of input into the decision-making procedure. The introduction of effective collective decision making structures will, on this account, perform a vital role in transforming private into public interest. Fostering effective participation and flexible and open constitutional arrangements should offer the basis for promoting greater governmental effectiveness. It is no doubt true that in a diverse, complex society a well-functioning democracy requires limits on the powers of the government. Rights provisions and structural limitations are important since they restrict the government's range of permissible actions and ensure that a deliberative sphere of public debate is protected. Harden and Lewis' reform model is structured on a theory of communication which serves as a basis for modernizing English constitutionalism.

Adherents of the Habermasian theory of communicative action might accept the view that rational deliberation is essential to a well-functioning democracy. Murphy (1989) has argued that Harden and Lewis' reliance on Habermas has lead them to produce a highly distorted reading of the British constitutional

tradition. He claims that consensual will formation, located exclusively in the hierarchical political elite, was the dynamic force which developed the British constitutional system. Murphy believes that Harden and Lewis, in developing their reconstructive project, have isolated the most salient features in the British constitutional tradition in order to justify their communicative model of deliberative democracy which is allegedly immanent within the constitutional tradition. Murphy's argument goes further. He argues that Harden and Lewis, like Prosser, by relying on the resources of the civil society to reform the state, tend to confuse and conflate the statist overcomings of the reified political system with the complexes of normative structures in the sphere of civil society. Put another way, normative structures located in the 'life world', such as post-conventional morality and communicative rationality, can not easily be substituted for the political logics which control and regulate the realm of political engagement. Murphy is skeptical of proposals that depend upon the deliberative capacities of free and equal agents to transform the political system. Murphy concludes that it is Harden and Lewis' reliance public participation and accountability which is curiously self-defeating since this strategy may paradoxically undermine the foundations of democracy.

Like Luhmann (1981; 1982; 1990) Murphy thinks that the normative dimension of civil society is obsolete, and that the institutionalization of power allows for the replacement of normative with cognitive expectations in the political system. It might also be argued that Murphy (1991) has redefined the notion of political society so as to include within the state those mediations which were once considered part of civil society. This strategy, which reduces the normative character of political system, means that Murphy is concerned more with the specialized role of the political system in stabilizing expectations and maintaining complexity rather than dealing with the highly charged domain of pluralist politics and democratic engagement. I find Murphy's argument less than convincing. At fault is his assumption, following Luhmann, that the media-coordinated sub-systems must be completely reduced to the logics of integration. Murphy's argument is based on the claim that society's differentiation is an empirical proposition. There have been numerous arguments which challenge the Luhmann's formulation of the differentiation of societal subsystems (Cohen & Arato 1992; Haverkamp & Schmid 1987; Munch 1992: 1463). The difficulties with the autonomy of subsystems approach is that 'empirical differentiation cannot be conceived of in terms of autopoiesis, because the autonomy of societal subsystems operating in the real world is permanently being produced and reproduced by a multiplicity of action elements which are both inside and outside an analytically defined subsystem (Munch 1992: 1463).

Harden and Lewis' vision of democracy reflects a liberal bias in favor of public dialogue and information exchange. It is optimistic in that it repackages liberalism by reference to normative value exchange will functions as a mechanism of resolving fundamental disagreement. The coherence of this modernist story is challenged by postmodernists on other grounds. Schlag (1990: 181), for example, states that 'it's really nice to think that we are all self-directing, coherent, integrated, rational, ordinary selves who are engaged in rational conversation in which we aim to resolve disagreement by resort to normative dialogue. ... It is all very nice. It is also absolutely unbelievable'. While proponents of the dialogic view of democracy believe that politics is something more than the world of the struggle of special interest groups which enter the political market in order to secure influence over government behavior, postmodernists are hard pressed to find anything more than bureaucratic practice, domination, and repression in the name of freedom.

In the end, hopeful modernists, like the Sheffield School, believe that it is possible to apply criteria to determine which substantive position is correct in order to transform private preferences in rational politics. There may be actual limits to Harden and Lewis' concern to enhance greater participation by promoting greater access to information. The requirement of more information, combined with reasoning giving and the consideration of more points of view, may not, in the end, facilitate greater dispersion of power or limit governmental discretion. Rather, it may be that a political system that promotes truth finding and continual discussion will ironically reduce the amount of information available and parties will seek to resolve their conflicts through opportunistic means.

II.

9.4 Transforming the State: Indeterminacy and Administrative Law

So far we have concentrated upon the ways communicative action and improved information exchange might enhance and improve the entire democratic constitutional process. We now turn to consider a slightly different modernist approach, one which concentrates on the indeterminacy of law as a source to generate a critique of legal rationality.

In the United States of American, early proponents of cls developed the indeterminacy critique as a means to challenge the liberal legal orders claim to rationality, i.e., concerning the autonomy and coherence of reason. These theorists attempted to demonstrate that formalist abstractions are necessarily

self-defeating and circular, and that the incoherence of doctrine could not be patched together by appeals to morality. Liberal thought was subjected to a vast array of modernist arguments offered to prove that law is contradictory and that the political project of modernity is exhausted. For cls proponents, liberal theory requires 'trashing' because it assumes that the law is basically determinate and this fact guarantees the requirements of the rule of law. These theorists believe that by undercutting the determinacy of law, i.e., its claim to reason, they will, in the process, delegitimize the role of courts and reveal that beneath surface of legal form swells the same ideological controversy which pervades the political sphere. Like their rationalist opponents, they believe that judges are constrained by legal forms although their decisions are based on their ideological preference orderings. The cls critique reflects a progressive belief that theory will assist them uncover the different forms of domination and provide the groundwork for an alternative, progressive view of the law (Fish 1993).

One strand of the British scholarship which emerged in the late 1970s to mid-1980s was heavily influenced by the theories Unger. For over a decade and a half, Unger has attempted a grand critique of liberalism based on a sociologically-informed theory stresses the importance on the indeterminacy of both legal doctrine and social context. Unlike the indeterminacy critique advanced by Kennedy, which posits an irreducible conflict between rules and standards, Unger's theory moves from the insight that there is no constant human nature and to the proposition that the self has the capacity to transform both the external world and is able to perpetually transform itself. This existentialist view of human agency is crucial to Unger's program of radical social empowerment, and the possibility of social transformation is based on the capacity of the self to achieve individual self transcendence. Unger's British followers, like Collins (1987) and Loughlin (1978), draw on his analysis of liberal legalism. This is an analysis which states that legal doctrine is ultimately indeterminate, contradictory, and subjective. Unger's (1987) concept of indeterminacy is based on a claim that the social structure, rather than language, is indeterminate. That is, where there is a conflict in underlying principles, Unger rejects the move to higher order norms or principles to resolve conflicts. He thinks that the conflicts in doctrine reflects a deeper set of divisions within society and it is hopeless to appeal to a higher level norms where none exists (Collins 1987: 398).

Applying the critique of liberal legalism to administrative law, Unger argues that public law is contradictory and indeterminate because the liberal forms can not be maintained as a result of the transformation of the state into a modern regulatory corporate state. It was the extension of the state into private

domains which structured and transformed the law in that its regulatory function involved a movement toward procedural and substantive conceptions of justice and a particularistic interest balancing approach to adjudication. Unger traced the transformation of the classical liberalism of the 19th century to the super-liberalism of the early-to mid-20th century. Modern legal doctrine contains individualistic and paternalistic elements and the irrationality of modern law results from the conflict between these principles. Unger believes, however, that an alternative vision of society can be worked out from the implications of indeterminacy. Locating the transformative potential in something he calls "negative capability," Unger maintains that it is our capacity to break through a specific context of action which presents the possibility for us to reappropriate the alienated political and economic domains and, at the same time, guarantees the possibility for personal transformation and freedom (i.e., changing the structures of social life presents the possibility of freedom concretised, which makes possible the reconciliation with the self and other). For Unger, liberal legal forms can not be maintained and justified because of the transformation of the liberal capitalist state into a modern regulatory state.

The first instance of Unger-inspired theory appeared in the U.K. in the late 1970s in the form of Martin Loughlin's (1978) early work on procedural fairness in the administrative state. For Loughlin, the classical model of liberal legality is specified in terms of its capacity for autonomous action, which guarantees that each person is treated equally before the law. There are two propositions that follow from this insight. First, the function of law is basically to ensure autonomy, which is seen as the free formation rather than the implementation of preferences. Second, political power is concentrated in the state and collective intervention as a rule is illegitimate if the relevant actors are content. A respect for the voluntary agreements of agents and divergent conceptions of the good is understood as an important guarantor of liberty.

Against this background, the state recognizes individuals as abstract rights bearers and exercises power through formal rules. Following Unger, Loughlin tells the now-familiar story of the growth of state intervention into previously private domains which causes a revision of the liberal legal order. Regulatory intervention transforms the liberal state into a welfare state and at the same time, modifies the form and substance of the abstract rule of law model. Because the state has new regulatory tasks, the law must be more policy-oriented and flexible. The bureaucratization of the law disrupts the apparent logic of the liberal model and leads to decay and a crisis of legitimation. The interventionist social state creates a new, informal, flexible concept of procedural fairness which produces contradictory results when applied within the traditional, formalist method of legal discourse. Loughlin contends that the introduction of the informal mode, based on a purposive style of legal reason-

ing, subverted the basis of certainty and symmetry which characterized the traditional model.

For Loughlin, a change in state and the new form of law which emerges requires a reorientation of public law theory. In order to locate new theoretical bearings, we must study welfare state law in terms of the law of administration. From this standpoint, Loughlin claims that we can avoid the problems of law-centeredness and eclecticism. Loughlin's argument is unpersuasive. His strategy is to expose certain confusions in procedural fairness that were created as a result of the changes in the state. However, he impermissibly extends, by analogy, this claim to cover the entire argumentative machinery of the public law, a typical mistake of early writings by American legal theorists. However, a deeper problem with Loughlin's explanatory framework is traceable to his naive assumption that the liberal rule of model was sufficiently coherent that the introduction of informality, as a result of the development of welfare state, exacerbated the logic of the liberal model. Loughlin's discussion of the welfare state is also flawed by the fact that, like Unger, he is committed to a logic of ideal types. That is, Unger's analysis of liberal-legalism implicitly endorsed a form of essentialism manifested in the assumption that the liberal legal system would collapse if its essential elements were displaced. Like Unger, Loughlin's analysis of the contradictions of the modern regulatory state depends on a highly overgeneralized logic of social forms which he then attempts to provide a new systematic vision of public law in order to work through the contradictory legal doctrine (Collins 1987). In this respect, Loughlin's critical project is distinctly modernist in that it attempts, via theory hope, to offer a different theoretical program to critique the state of modern state practice.

9.5 Late Modernism: Systems Theory and the Central-Local State

Loughlin later modified his views when he turned to consider the relationship between the central and local state. He continued to argue for a theoretically-oriented conception of public law, embracing functionalism in his attack on the new normativists (1992: 184-229). Loughlin is no longer committed to the modernist dualisms of individual/society and state/society. Such dualisms, in particular the state and society divide, attempt to create a false unity while distorting our capacity to adequately capture a coherent vision of society. Further, the problem with the state/society duality is that it entails political neutrality in the non-state spheres. Loughlin's attack on the unitary state is an integral component of his functionalist theory of public law.

Loughlin endorses a version of functionalist theory which is derived from the

modern systems theory, as it has been developed by Luhmann (Loughlin 1992: 250-260). As we have seen, Luhmann (1981) argues that with the shift to a society dominated by the market, it is no longer possible to understand society simply in terms of a political or normative conception. Luhmann's theory is partly based on a historical understanding of the development of society since the 18th century. He states that an important consequence of the decline of simple segmentary society is the passing of the importance of legitimation or consensus. With the emergence of the hierarchical form, based on internal and external differentiation, a different approach to the environment develops (Luhmann 1981, 1982). As the social order becomes increasingly more complicated and differentiated along subsystem lines, there is less need for social consensus and more need for system internal modes of communication (Luhmann: 1981: 125-29). Society, from this point of view, is now composed of a series of differentiated subsystems which are based on their own means of integration. From the systems point of view, the differentiation of the political system entails the decomposition of civil society and its role in mediating the conflicts between the economic and political system (Luhmann 1981). The implication of Luhmann's claim is that a functionally differentiated social system does not generate external standards by which to evaluate the behavior of the political and legal systems.

Following Luhmann, Loughlin believes that liberal normativism is obsolete and serves no useful purpose in framing public law discourse. Liberal normativism, or even the primacy of a generalized morality, as a basis for legal reform, is now a thing of the past (Loughlin 1992: 243). The difficulties and ambiguities which beset normativism are related to its failure to account for the changed forms of the modern political-administrative state. Thus, Loughlin argues that the language of liberal normativism depends on an 'ideological grid' from an earlier era which is unable to adequately recognize the new social or legal forms emerging in the later part of this century. Loughlin offers evidence for this claim. Loughlin looks to the local state/government conflict over control of local state activities as an example. He argues that the move by the central state to employ a range of legal forms to regulate the local state reveals a shift away from an internal system of regulation to a system of external intervention based on judicial review and administrative rules. It was the national state's introduction of financial accountability and reduced financial expenditure which was instrumental in the growth of the 'normative gap' between the internal complexity of the local, administrative system and the legal and political language used to describe it. Loughlin's point is that social structures in England have changed over time and the meaning of concepts like democracy, sovereignty, and law have changed dramatically so that they no longer mean what they did to Dicey (Loughlin 1992: 230-31). For Loughlin a functionalist

public law offers numerous advantages over the liberal, normative model. His thesis is ultimately pragmatic: functionalism gives public lawyers an interpretative theory which most closely approximates the changes in modern society.

Loughlin's account of political society is directed against modernist's accounts of politics which look to the collective pursuit of associationally determined goals as the legitimate basis for the regulation of action. Loughlin's functionalist program reflects a general decline in confidence in the use of the law to promote social change. In the 1980s, there was, as we have seen, a tendency on the part of the British government to avoid the full legislative process in matters of financial importance to the government (Graham and Prosser 1991: 34-70; Craig 1990: 187-92). Loughlin contends that the normativist accounts, their new reform projects, depend on a reality which has been carefully eroded and which no longer exists. On the other hand, functionalists believe that the positivization of law has broken the connection between law and social reality and, as a result, modern societies are no longer based on a pre-mediated concept of justice. On this vision, the legal system operates to institutionalize norms, which are defined in terms of counterfactually stabilized expectations. The legal system operates to stabilize expectations through the use of sanctions and procedures. Unlike the normativists, who look to dialogue and reason to foster reform, functionalists, like Luhmann and Loughlin, insist that all talk about principles can be translated into norms that regulate the production of norms.

A theory of public law informed by functionalism is intended to redefine the relationship between law and the state, where the normative dimension is only relevant in terms of explaining how new networks of power operate. However, Loughlin's treatment of the positivization of law may not be an adequate reason for abandoning certain advantages of normativism. To be sure, I agree with Loughlin (1992: 260) that there have been changes in the structure and function of the modern state which 'has directly confronted our traditional government structures and has led to major changes in the organizational frameworks of government'. The new legal measures introduced have, for the most part, been the result of political and economic considerations. I am not convinced, however, that the problems of modern law in Britain can not be adequately addressed by reference to normative investigations regarding the form and nature of public participation in government. In contrast, I believe that it is crucially important to consider new intermediate political institutions which might serve to filter or launder the preferences of individuals. It seems that one of the principal tasks is to design a new set of constitutional institutions which incorporate elements of pluralism and the ideals of civic virtue which make participation a significant part of a well-functioning democracy.

Loughlin's central point is not always clearly linked to the fortunes of functionalism. This can be gleaned from his recent account of functionalism (1992: 264). Loughlin, after challenging all the new normativist initiatives which call for constitutional reform, exhorts public lawyers to adopt, as their 'principal focus[,] the examination of the manner in which the normative structures can contribute to the tasks of guidance, control and evaluation of government'. Despite his attempt to close law off from its normative sources, Loughlin finds it hard to defend his functionalist position without turning to the substantive principles of normativism and their claims to validity. This can most easily be seen in his discussion of *Bromley L.B.C. v. Greater London Council*, where Loughlin (1992: 262-63) is more concerned with attempting to get right the appropriate standard of review and understanding of the government grant system than pointing out that the right answer is only relevant to the extent that it assists in the smooth processing of the legal system. This apparent contradiction in Loughlin's position is a result of being caught in more than one cognitive framework. The irony is that Loughlin employs a thorough going post-modernist argument to deconstruct public law but, after he has pulled out the ladder from under the normativists, he attempts to redraw the ladder of normative thought, despite himself.

III.

9.6 Nihilism and the End of Law

During the last decade the efforts by legal scholars to develop an alternative jurisprudence has given rise to an interest in post structuralism, deconstructionism, and semiotics. This cluster of contemporary philosophical movements have been described as 'postmodern' because they see themselves as challenging the philosophical tradition of the Enlightenment. The implications of the postmodernist model can be highlighted by focusing on Peter Goodrich's work.

Postmodernists offer a radical and far-reaching argument against the Enlightenment's claim to rationality and objectivity. It challenges the modernist reliance on identity logic. The role of the subject, as an autonomous agent capable of generating her own source of meaning, is challenged. The subject is shown to be socially constructed and their subjectivity is thought to depend on institutions and organized scientific discourses which rationalize society. On this view, the subject is no longer the source of meaning and change in society. Indeed, the autonomy of the subject as a source of rationality is viewed as a pretension of the Enlightenment which should be abandoned.

Postmodernists, like Goodrich, embrace nihilism as a critical standpoint against the Enlightenment tradition. While Goodrich notes that the traditional concept of nihilism, as it has been traditionally employed by legal theorists, is theoretically impoverished, he offers a theoretically more robust notion. For Goodrich, nihilism is defined in terms of the 'generalized loss of belief in the order and breakdown in legitimation of dominant general theories of the good and institutions in society' (Goodrich 1986: 548). Nihilism addresses the problem of modernity by challenging the dominant values embodied in legal texts and disrupts the dominant view that law and morality are co-extensional. The rationale for nihilism is that it is the last hope in the face of an oppressive and dominant tradition of reason. Let's consider what a critique of law, based on nihilism, amounts to. Goodrich's thesis is evident from the preceding paragraph: a critical legal theory involves a rejection of legality and the substitution of justification for a textual-based strategy, based on the deconstruction of the common law tradition. Like most modernists, Goodrich believes that a methodological technique, like the concept of legal discourse, will reveal something about the relationship between the legal system and power.

Having rejected the Enlightenment vision of legality and the suprahistorical perspective of grand theories, Goodrich proceeds to articulate his own theory of law. He advocates a theory based on a concept of legal discourse which serves to show that legal meaning is constructed, structured, and disseminated by a regime that, despite local resistances, controls and shapes persons and knowledge. In its essentials, the argument is that the normative juridical discourse conceal relations of domination which are the real foundations of the institutional practices of modern law. Discourse analysis is principally concerned with the strategic interpretation of the law. It would appear that Goodrich's concept of legal discourse, while explicitly rejecting the aims of immanent critique, retains a part of the modernist aspirations of theory in that he believes that the power of discourse analysis can be strategically interpreted for the use of the other, which appears to be a disguise for the return of the Kantian subject. Thus, the discourse model, based on nihilism, is a reconstructive exercise which is ironically similar to Unger's context-smashing, deviationist doctrinal work.

Recently Goodrich has returned to the addressing the problem of the authority of law. When Goodrich (1987) comes to the characterizing the nature of legal authority he states that the social order can not be grounded on the authority of law because the center of the legal system is 'pure mythology', more rhetorical than actual. Like Foucault, Goodrich argues that the legal system operates through rhetoric to divert attention away from the actual social facts that determine its substantive rules. By avoiding the distinction between

legitimate and illegitimate sources of power, Goodrich directs us to look at how power is localized in particular discourses. The law is principally a discourse of power which conceals its conditions of production through a series of rhetorical techniques. Goodrich wants us to look directly at the real forms and techniques of power. He, like Foucault, believes that the source of law's power is located in extra-legal sources which the rhetoric of law systematically denies. With this conception of the liberal-legal system, Goodrich's (1990: 17) critique of law amounts to focusing our attention to uncovering the forgotten or suppressed 'history of another possibility', a failed history which 'maps another possibility'.

The most prominent type of criticism which has been levelled at Goodrich is that the project of uncovering the practices which have been forgotten 'is no more free of forgettings than the project which he excoriates'. (Fish 1993: 71). The task of attempting to take everything into account, in fashioning an interdisciplinary critique of law, is self-defeating. Fish (1993: 71) regards Goodrich's attempt to locate a more inclusive discourse unlikely to improve the functioning of law, which he declares is 'simultaneously declaring and fashioning the formal autonomy that constitutes its precarious, powerful being'. The force of Fish's critique is that Goodrich is seeking to locate, on a more abstract level, a unity in law which is directed towards something quite outside the function of law. It is, therefore, a normative exercise which has something more to do with the bureaucratic practices of the academic world than the needs of actual legal practice, which are based on a series of 'rhetorical tricks'. Much of Goodrich's discussion is an attempt to generate a better, more inclusive, view of the law. Despite his protestations, Goodrich appears to be practising a version of modernist theory.

9.7 The English Common Law and the Social Contract

If we turn to Goodrich's more recent work (1990) it would appear that he has abandoned his reform-minded, interdisciplinary project and adopted a more thorough-going, postmodern account of law. In *Languages of Law*, he employs a semiotic method and French-inspired psychological theory (Lacan and Legendre), to unravel the forms and appearances of the law and attempts to show how its different forms legitimate the practice of law for the legal subject. A semiotic theory focuses on how the law creates a space for communication and the different modalities it employs to render meaning intelligible.

Goodrich's theory of law is based on a reconstruction of the English common law. The English common law is a set of norms or practices which together

constitute a single, unified tradition (Goodrich 1992: 7). That is, the English common law is 'a tradition tied to the land and the people, a memory of the past that extends beyond "the memory of man"'. [Central to the common law tradition is the view that] 'the law itself is a religion' (Goodrich 1992: 13). The English common law is also an expression of 'how things are done' and the common law establishes not only religion but truth and authority. The common law is a system of memories, 'a time immemorial usage' in which the norms and practices of the past are found embedded within legal language. The common law is also the law of a nation and it is the excellence of the common law which is 'a political argument against foreign influence' (Goodrich 1992: 15).

In approaching the history of the common law, Goodrich's aim is to deconstruct the myth of the common law and demonstrate how it sustains its authority through 'a mixture of image, myth, oral memory and written text, custom and judicial legislation' (Goodrich 1992: 8). It involves a critique of the normative conception of legitimation, law, and rights. Following Foucault, Goodrich explains that the modern technologies of the state and law are linked to a discourse which played a central role in establishing the monarchy and constitution. Goodrich (1990: 227) states that: 'The two principles of English constitutionalism, those of monarchy and secrecy, of an aura or display of power that simultaneously hides the logic of its practice, can be traced without difficulty or too great a degree of digression into the common law itself'. The authority of law is linked to a myth which structures the symbolic points of reference for all legal subjects and establishes an institutional order in which the truth is the foundation of legal discourse.

A highly stylized vision of the English common law system is the background against which Goodrich describes the development of the secularized discourse of modern democracy. Like Derrida, he understands the law of the constitutional state as a legitimating discourse by virtue of its reliance on norms, rights, and justice. Postmodernists, like Goodrich, believe that the normative principles of right and legitimacy are anachronistic. They follow Nietzsche's (1954: 160-61) claim that the: 'State is the name of the coldest of all cold monsters. Coldly it tells lies too; and the lie crawls out of its mouth: "I, the state, am the people." This is a lie!' In particular, postmodernists deny that the modern forms of procedural democracy, which was initially developed by Rousseau, are not sustained by the consensus of citizens but rather the legitimating force is the imposition of the law is founded elsewhere, i.e., external to the social. The founding of the law is based on a text which 'can be considered as the theoretical description of the State, considered as a contractual and legal model, but also as the disintegration of this same model as soon as

it is put in motion' (de Man 1979: 253).

In reality, the system of constitutional democracy is based on a tradition which attempts to base its legitimacy on the voice of the people, although the paradox is that the people are absent and that the contract is based on an agreement that never occurred (Goodrich 1990: 322). Goodrich, like de Man before him, contends that the social contract is a simulacrum. That is, 'the sender and receiver of the message are one and the same; the contract separates the parties to the exchange simply so as to unite them indissolubly, textually, legally' (Goodrich 1990: 171). De Man (1979: 274-75), points out that '[t]he metaphorical substitution of one's own for the divine voice is blasphemous, although the necessity for this deceit is implacable as its eventual denunciation, in the future undoing of any State or any political institution'. The paradoxical quality of the social contract is the source of law itself. Indeed Samuel Weber (1990: 1536) defines that problem of the law, defined in terms of the *Social Contract*, 'can be formulated, accordingly, as that of translating an unconditional (anonymous) promise into a conditional (nominal) one. 'According to Goodrich (1990: 171), the law is closed off in the sense that 'the contract is that which excludes, it is that which immunizes us against other discourses and precludes that we even think of any other law'.

Goodrich's account of the social contract and democratic institutions leads, I think, to a deeply disturbing concept of the law and the modern democratic state in which there is a complete loss of the social and the normative resources of civil society. He explicitly attacks the system of mediation which is responsible for producing the juridical and political transformation of modern society. Goodrich, by returning to Rousseau, is challenging the juridical foundation of the modern state which he contends is masked and mystified through the paradoxical concept of the general will. He wishes to deny the modernist distinction between legitimate action and the exercise of power in order to challenge the claim that civil society and its normative resources are the foundation for right. Here again, we must see that Goodrich is not attacking civil society but the separation of civil society from the state. Postmodernists are committed to defending the proposition that civil society is not separate from that state but intimately bound up with it.

Ironically, Goodrich selects Rousseau as the contractarian whom he wishes to single out as the theorist who represents the enclosure of the political world by reference of a displaced metaphysical other. Indeed, it was Rousseau who was a fierce critic of the contractarianism of Hobbes and Locke. The origin of society, for Rousseau, was not to be founded in a contractual agreement (Rapaczynski 1987: 254). Against Hobbes and Locke, Rousseau therefore

denies the natural rights tradition's claim that the individual can be understood scientifically. Rousseau differentiated state from civil society in order to show that only a high degree of normative development makes possible the reflexive structure of the social contract (Rapaczynski 1987: 254). Recently, Preuss (1993: 658-59) has argued that Rousseau's contract involves a high degree of social cooperation which is 'necessary for the inherent justice and orientation towards the common good and society'. Preuss believes the conditions of the general will, measured in terms of social cooperation, will ensure that the social contract tracks the interests of the members of the community. Interestingly, Preuss (1993: 659) argues that Rousseau's social contract reflects the concept of the nation built on a constitutional state which presupposes 'a minimum degree of prepolitical sameness and homogeneity of the constituent power'. It is this vision of the nation, in particular England, which Goodrich (1992: 9-15) finds disturbing. In England, constitutionalism has been built on a rather narrow set of beliefs which have been justified by a series of legal symbols which are embedded in a closed and sterile symbolic field of endless repetition. In this regard, I agree with Goodrich that the English tradition has meant the exclusion of the idea of pluralism and democratic input.

I disagree with Goodrich, however, when he attempts to extend his analysis by construing all democratic society as nothing but the effect of power relations. At this point the idea of plurality drops out of his analysis and he offers a genealogy of the legal subject as an attempt to demonstrate the normative bankruptcy of democratic participation. The upshot is that liberal institutions are incapable of granting citizens a space where they can deliberate and self-reflectively constitute their society. I find that Goodrich's account is too highly politicized. I agree with him that legal institutions are exclusionary and limiting but this proposition does not conflict with the idea that they operate to process the normative claims of diverse groups in society.

It seems to me that modern society is organized into many diverse overlapping communities of judgment (Rawls 1987). The different identities of individuals are taken into account by constitutional structures and protected to a certain extent. In this regard, constitutions provided the basis for preserving a common identity (Holmes 1988: 29). To a certain extent, constitutionalism is committed to a different constitutional identities due to its commitment to equality (Rosenfeld 1993: 526). The accommodation of different identities is reinforced by constitutionalism commitment to toleration which involves mutual respect (Gibbard 1990: 243-246). While I am not persuaded that constitutionalism is the only meta-discourse which can harmonize the normative conflicts among the various groups, I tend to think that certain constitutional structures are more effective in producing compromises than others. A self-limiting, political

concept of constitutionalism is best understood as a post-liberal theory which relies on certain modernist and postmodernist arguments. It has less to do with the concerns of truth and rationality and is more concerned with developing a practical and pragmatic structure for fostering agreements on political, social, and economic questions.

Unlike rationalist or modernist theory, a post liberal view of constitutional politics is based on an anti-foundationalism which, at the same time, is not committed to relativism (West 1988). Eschewing theoretical language based on metaphysics or epistemology, a post liberal theory accepts the hard realities of normal politics and attempts to introduce new reforms to make political competition based on a regulative ideal that serves to reinforce political equality at the level of institutions (Beitz 1989: 17). It has been argued that constitutionalism based on interest group bargaining is a relatively low cost way for under-resourced groups to express their normative standpoint and it provides an expressive means for registering the intensity of a preference not otherwise accounted for within the traditional processes (Cohen & Rogers 1992: 412). On this view, a system of pluralist representation suitably reformed to provide fairer representation and access to political resources, offers a suitable mechanism to launder the preferences of groups without relying on a theoretical standpoint grounded in objectivity or communicative rationality (Cohen & Rogers: 1992; Beitz 1989). An effective constitutional democracy offers an effective structure for institutionalizing preferences and, at the same time, operates to channel potentially destructive disagreements (Holmes 1988:23). Thus, I would argue that a post liberal constitutionalism is more likely, in a highly competitive and diverse society like our own, to promote limits on majoritarian rule and promote the representation of minority interests. In this regard, the institutions and procedures are likely to be reinforced commitment depending upon their success in limiting conflict and ensuring effective representation.

9.8 Conclusion

I suspect that the warm reception of postmodern theory in British cls is based on the popular view that it provides a basis for purging our thought of its foundationalist visions based on Enlightenment concepts of the subject and rationality. This view ignores the fact that postmodern theory appears to reject the possibility of political institutions based on the internalization of norms. However, there appears to be an inconsistency between the postmodern suspension of the normative dimension of politics and their recourse to a pure discourse of power. Postmodernists must either ignore the norms generated by associations or conceive of them as strategic and therefore not democratic.

It would appear that the postmodern theorists is unable to refer to positive set of norms to articulate a radical alternative. What emerges is a highly political argument which understands modern democratic institutions as defective and disabling. A more productive alternative would be to recognize that political institutions have a strategic and normative dimension and that the democratic structures are still capable of processing the preferences of interest groups and the new demands of political movements and shadow interest groups.

CHAPTER 10

DEMOCRATIZATION AND THE PARADOX OF TRANSITIONS: BARGAINING, DISAGREEMENT, AND INSTITUTIONAL DESIGN¹

10.1 Introduction

Nearly everyone considers themselves a democrat today. Yet, there is very little agreement regarding what it means to design democratic institutions that are responsive to and respectful of the diverse ethnic, social, and economic groups that are competing for position and material advantage.² This is particularly clear in highly differentiated societies in which the ethnic, religious, and political conflicts can lead to the fragmentation or even the re-drawing of political boundaries.³ While the collapse of the Communist regimes in Eastern and Central Europe created an opening for the development of new institutional arrangements and the expression of constitutional norms, we are now witnessing difficulties in the democratization process, due to re-newed nationalist conflict fuelled ethnic clashes and distributional conflicts.

The current transformations are taking place in the shadow of discredited yet established institutions which though disintegrating had their own institutionalized pattern of vested interests. In certain instances, the pattern of reform has been slowed because of the political pressure various groups are able to bring to bear on the politicians.⁴ Because the commitment to the introduction of modern democratic constitutionalism depends on the degree of interest group support for the new system of property rights and democratic representation, the level of support for change varies across states, given the economic

¹ This chapter appeared in K. Itoh, *Democratization in the 1990s* (Nagoya: University of Nagoya Press, 1997).

² J. Elster, 'Constitutionalism in Eastern Europe', *University of Chicago Law Review*, 58, 2 (1991) 480-1.

³ A. Buchanan, *Secession: The Morality of Political Divorce from Sumter to Lithuania and Quebec* (Boulder: Westview Press, 1991), esp. ch. 1.

⁴ M. Dewatripont and G. Roland, 'The Design of Reform Packages under Uncertainty', *American Economic Review* 85, 5 (1995) 1207-23.

circumstances, ethnic composition and the history of constitutional decision making.⁵

Yet, the crucial aspect of the project of democratization process involves not merely changes in the 'rules of the game' but also the replacement of the old norms and practices with a new set of values and assumptions. For example, the introduction of modern constitutionalism changes the relationship between the identity and diversity of the agents engaged in the political process.⁶ Modern constitutionalism relies on an abstract and concrete constitutional identity, which finds its legitimation from the political actors who reached the original coalitional agreement. Hence, in a modern constitutional regime, the system of fundamental rights operates at an abstract level as a backstop to impose a structural constraint dictating the protection of all fundamental rights. It is almost certainly true that modern constitutionalism accounts for a range of different identities as far as they can be interpolated within the protection of fundamental interests. To be sure, the relationship between identity and difference can be unstable and the institutions of a constitutional democracy will tend to reflect the tensions between identity and difference in society. But the real problem is that some of the new structures are incomplete in that they do not really resolve these underlying cleavages in political society.

There is a sense in which the problem goes beyond mere incompleteness. For the most part legal and political theorists have had little to say about the conditions under which a set of stable democratic structures could be created in societies in which territorial, ethnic, linguistic, religious, or economic divisions make it difficult for institutions to enable individuals to effectively engage in deliberative politics. They tend to focus on the contract device or a single constitutional mechanism (e.g., Madisonianism) for devising a scheme which secures democratic legitimation.⁷ This static way of attempting to accommodate the abstract moral principles of equality and liberty with the diverse political and bureaucratic processes without, for example, an investigation of the barriers to constitutional practice (e.g., society's ethnic divisions), tends to produce a functional model of democracy.⁸

To be sure, the search for a justification of generalized conceptions of

⁵ See generally, I. Pogany, 'Constitution Making or Constitutional Transformation in Post-Communist Societies?', *Political Studies* 44, 3, (1996), esp. 579-89.

⁶ Michel Rosenfeld, 'Modern Constitutionalism as Interplay Between Identity and Diversity: An Introduction', *Cardozo Law Review* 14, nos. 3-4 (1993), esp. 508-14.

⁷ See generally, J. Elster, 'Constitutional Bootstrapping in Philadelphia and Paris', *Cardozo Law Review* 14, 3-4, 549-75.

⁸ U. Preuss, 'Constitution Powermaking for the New Polity: Some Deliberations on the Relations Between Constituent Power and the Constitutions', *Cardozo Law Review* 14, 3-4 (1993) esp. 648-59.

democracy itself is complicated by the fact that there are a plurality of political principles which could serve to legitimate the constitutional decision-making process. And because these models are generally static and take preferences as given, the purely functionalist account does not look to new conditions which shape our preferences. At the same time, we are unlikely to find legal theorists supplying reasons for choosing one set of institutions over another. For now, we are left with arguments about what democracy requires (i.e., constitutional constraints, judicial review, etc.) or how concerns regarding how a transitional constitution-making body can legitimate its procedures (e.g., the amendment procedure) to create new institutions. This leaves many questions unanswered about the relationship between liberal political principles and organizational design.

To be concerned with the design of constitutional mechanisms for the coordination of crosscutting cleavages in society entails that we must begin to look for broader and deeper theoretical approaches which engage not only with the conditions for the development of democracy, but examine the social and political sources of constitutional decision-making. In saying this, however, I am not denying that this work has not already commenced. There are reasons to suspect that the recent contributions of rational choice theorists on the subject provide a basis for thinking that this conception of democratic analysis is beginning to take shape.⁹

This influential perspective purports to offer an account about how political institutions evolve and an objective explanation about the transition to democratic institutions. Rational choice theorists insist that constitutions are complex mechanisms designed to coordinate society.¹⁰ They rely on an instrumentalist account of preferences to show how the conflicts over political choices can lead to coordination problems. However, proponents of rational choice theory emphasize that political institutions may evolve to equilibrium, based on the optimal selection of social choice rules. But they insist that the instability inherent in majority rule makes this outcome uncertain. Political institutions can serve to stabilize expectations. Rational choice theory tells us that the instabilities created by ethnic conflict, redistributive politics and other deep cleavages can be accommodated by the traditional range of democratic mechan-

⁹ See, P. Ordeshook, 'Some Rules of Constitutional Design', *Social Philosophy and Policy* 10, 2, (1993) 198-232; A. Przeworski, *Democracy and the Market* (Cambridge: Cambridge University Press, 1991).

¹⁰ I use the term 'rational choice' in the general sense. It is now well established that there are a range of literatures (i.e., public choice, social choice, positive political economy, etc.) which are easily grouped under the rational choice rubric. D. Green and I. Shapiro, *Pathologies of Rational Choice Theory, A Critique of Applications in Political Science* (New Haven: Yale University Press, 1994) xi.

isms.

Could rational choice theory do a better job in designing constitutional structures which stabilize the expectations of the diverse and often conflict-ridden groups than the theories of constitutional law supplied by lawyers? Presently none of the standing legal theories supplies the necessary arguments for the design of alternative institutional devices which could coordinate these cleavages. In this respect, any successful account of understanding the process of institutional transition must begin to draw on a variety of new institutional approaches which draw on such devices as punishment strategies, reputation, and other-regarding norms to foster insights about the shape of institutional arrangements.¹¹ By examining human conceptions of attitude, rather than behavior, we are alerted to the fact that political outcomes are not just the product of rational expectation. They involve broader concerns which may not easily fit within the traditional models of social choice. I shall argue that the rational choice description relies on a narrowly focused account of political actors' motivations and cannot supply an adequate interpretation, in the broad sense, of the social dimensions of collective decision making.¹² Any claim about how democratic institutions can resolve moral and political conflicts must, therefore, be based on an interpretation of expressive meanings and practices in the context of institutional choice, and not in some isolated way from the evaluation of democratic institutions.¹³

The theme of this paper is that the development of institutional structures, based on diverse and conflicting values, provides for a feedback mechanism required for regulating democratic systems. This vision involves a recognition that the formation and coherence of the constituent power of society can not be the creation of a social contract of individuals. It is argued that a democratization is best understood as consisting of a bargaining process which, depending on the diversity of political settings and identities, occurs in the context of existing institutional arrangements, and subject to the constraints of normal politics. Hence, the task of designing new democratic institutions, which reflect a compromise between the competing groups, must be struck on the basis of pragmatic process and structure principles, which work to further enhance the institutionalization of constitutional decision-making.

The upshot of the discussion is to show that in conflict situations, where

¹¹ W. Riker and D. Weimer, 'The Political Economy of Transformation: liberalization and property rights', J. Banks and E. Hanushek (eds.) in *Modern Political Economy, Old Topics, New Directions* (Cambridge: Cambridge University Press, 1995) 93-99.

¹² Rational choice theory pursues a behavioral strategy in trying to derive cooperation (i.e., resolving Prisoner's Dilemmas).

¹³ See generally, Philip Pettit, 'Virtus Normativa: Rational Choice Perspectives', *Ethics* 100, 4, (1990) 742-750.

there may be proposals from many different groups, it is possible to explain conflict and cooperation by reference to a norm-based approach.¹⁴ A satisfying account approach to democratization links norms to their contextually-generated rule-making decisions. Accordingly, this model offers a more robust alternative to the individual behavior approach to political choice. This model seeks to explore the function which precedent-based institutions (i.e., constitutions) provide for opening up the space for the establishment of social roles, and the institutionalization of historical and contextually-based actions.

10.2 Procedural Theories of Democracy and Moral Conflict

The proponents of the institutionalist version of radical democratic change conceive the task of establishing new institutional structures in Eastern and Central Europe so that they may reflect the will of the people. The new regimes have a common objective: to incorporate the ideals which initially led to revolutionary transformation of society. The radical-institutionalist solution depends on an optimistic view of democratic structures. That is, majority rule, once implemented, will continue work to successfully to produce political outcomes that manage to reflect the preference that the majorities of the people (who made the revolution) would prefer.

This section will argue that the idea of populist democracy is essentially static in that its defence of majority rule relies on a set of stable and fixed preferences. The majority rule requirement which lends weight to the claims of the greatest numbers works to institutionalize exclusion of the minorities which disagree on the claims of the majority. My task is to show that this model leaves no room for resolving the potentially conflicting concerns about the terms of democratic politics.

We begin by critically assessing the radical institutionalist view that democratic institutions must satisfy a substantive conception of procedure in order to legitimate the products of political and lawmaking institutions. Traditionally, the popular will vision of democracy asserted that democratic outcomes should be made by reference to the will of the people. A central premise of this perspective is that the coherence of a polity is predicated on the individual's decision to consent to participate in a group concerning the direction of the common good of society. It is assumed that the members of civil society have achieved a certain level of pre-political unity in order to satisfy the level of

¹⁴ See e.g., G. Garrett and B. Weingast, 'Ideas, Interests, and Institutions: Constructing the European Community's Internal Market', in J. Goldstein and R. Keohane (eds.) *Ideas and Foreign Policy: Beliefs, Institutions and Political Change* (Ithaca: Cornell University Press, 1993) 181-87.

cooperation necessary to transform the people into a constituted power.¹⁵ The weakness of this assumption is obvious. In many countries undergoing reform, the lack of shared belief systems has led to costly disagreements over the terms and pace of the transition.

The radical institutionalist view asserts that democratic consequences have significance only if the political outcomes are derived from the individual judgement of citizens. Proponents suppose that the structure of decision making must be based on the actual individual judgments of the people. This is an instrumental claim about social decision procedure serving merely to translate the judgements of the citizens for the purpose of legitimating political decisions. Proponents argue that the majority rule method is the best decision procedure since it connects the principle of procedural fairness to political outcomes. The paradigm apparently has a straightforward explanation for how political decisions of democracy are deemed legitimate: a fair social choice procedure which conforms to the general will. The model's policy prescription supports a general presumption favoring legislation which is the result of majority decisions.

With the populist picture we get a simple mechanism for resolving complex moral disagreement. The institutionalization of substantive political equality means that the majority has the right to resolve the moral and political conflicts of the polity. Under this view, majority rule serves only to resolve substantive moral conflicts on procedural grounds. In effect, the device of numerical rule imposes duties on the minority to consent to the resolution of conflict. Hence, under a purely procedural arrangement the requirement of political equality supplies the norm which resolves the substantive moral and legal conflicts among groups.

But the plausibility of the populist's presumption in favor of majority rule decision making depends on the robustness of its assertions that there is evidence of a connection between the general will and social choice procedures. That depends, in turn, on the coherence of the model's conception of democracy and its view that public confidence is linked to the fairness of procedures. The proceduralist model, in fact, is well known for its weaknesses. First, the majoritarian framework relies on decision procedure which is unable to resolve most moral conflicts without introducing substantive values regarding the democratic process itself. Populists acknowledge that while the majority rule model offers all citizens an equal right to participate, the majority principle works to transfer power so as to create hierarchies and institutionalize advantage. In response, most theorists accept that procedures must be modified

¹⁵ U. Preuss, 'Constitutional Powermaking for the New Polity: Some Deliberations on the Relations Between Constituent Power and the Constitution', *ibid.* p. 642.

in order to produce some more favorable outcomes.¹⁶ Because substantive moral and political conflicts are resolved by reference to voting rules and other kinds of democratic institutions, proceduralists supply criteria of fairness to assess the structural characteristics of political procedures.

On this view, democratic politics requires a set of institutions which foster deliberation based on the expectation that every citizens could accept the outcome of the terms of participation. Thus, by introducing normative considerations, in order to harmonize the interests of minorities, the procedural democrats are drawing on a substantive value to justify the outcomes of democratic decision making. It turns out that the proceduralists, rather than resolving the problem of moral and political disagreement, have merely responded to the dilemma by coming up with their own view about which commitments a democracy should support and respect. And so it turns out that the procedural model can not provide an adequate solution to the complex problem of moral and legal conflict.

But the problem goes beyond mere resolution of moral conflict, for the procedural model of democratic choice is inadequate for satisfying citizens' preferences. In particular rational choice theorists show that there is a very weak (if non-existent) connection between the popular will and the lawmaking activities of the government. It is doubtful that the democratic rules of collective action can achieve fair and meaningful results.¹⁷ Arrow's Possibility Theorem showed that under certain conditions, no unique majority will emerge. The Arrow result demonstrated that when there are three alternatives on the agenda and two or more individuals, there exists no social choice rule which satisfies the minimum fairness conditions will produce a transitive social ordering.¹⁸

The Arrow model is a generalization of the paradox of voting which was first discovered by Condorcet and is now construed as the problem of cycling majorities.¹⁹ Arrow's insights were extended by McKelvey's²⁰ global cycling theorem, which shows that when there is no majority winner, then any two

¹⁶ C. Beitz, *Political Equality* (Princeton: Princeton University Press, 1989) 76-91. See also, A. Gutman and D. Thompson, 'Moral Disagreement in a Democracy', *Social Philosophy and Policy* 12, 1, (1995) 96-99.

¹⁷ William H. Riker, *Liberalism Against Populism* (San Francisco: W.H. Freeman, 1982). Riker's results have been challenged, see generally, Jules Coleman and John Ferejohn, 'Democracy and Social Choice', *Ethics* 97, 1 (October 1986), 6-25, esp. pp. 18-24.

¹⁸ K. Arrow, *Social Choice and Individual Values* (New Haven: Yale University Press, 1951) 12-13.

¹⁹ Charles Beitz, *Political Equality* (Princeton, Princeton University Press, 1989) p. 68.

²⁰ Richard McKelvey, 'Intransitivities in Multidimensional Voting Models and Some Implications for Agenda Control', *Journal of Economic Theory* 12 (June 1976), pp. 472-82.

points in space will belong to a cycle. The fundamental idea of the voting paradox is that cycling is possible when taking a decision. Thus, for example, if we assume majority rule, is possible to cycle through different preferences. Assume that there are three players, A, B, and C and three alternative outcomes, a, b, and c, and the following preference rankings: A:abc, B:bca; C:cba. The result is a lack of transitive social ordering (ie., cycling).²¹ It may be that some cycles are less likely to emerge due to a range of factors, including the normal operation of the political process. However, in other respects, instability is a feature of the democratic system. The concept of global cycling has important implications: Cycling calls into question the possibility that democratic procedures can render a fair and stable arrangement. Under this diagnosis of the infirmities of democratic procedures, proponents go on to argue that the 'public interest' can not be meaningfully articulated in the first place, much less utilized as a template for regulation.

It can now be said that Arrow's result creates a problem for the populist conception of democracy. As pointed out earlier, we know that because majority rule does not lead to a unique social welfare function, it follows that democratic theory should not rely on the idea of the popular will as the principal basis to legitimate political outcomes. Breaking the link between voting and the general will opens up the question whether there is a basis for democracy institutions formed by reference to the coherence of a social group.²² Clearly the arguments just presented support the conclusion that the popular will conceptions of democracy are incoherent, and the proper aim of democratic theory is to design effective institutions.

²¹ As noted, the voter's paradox occurs only when there is a multi-peaked distribution of preferences. To be sure, Arrow's paradox depends on the assumption that we ignore the measure of intensity with which preferences are held by individuals. Recently, Binmore has argued that if this condition was less stringent, a conception of the common good could be expressed by looking to cardinal utility information. He makes an interesting suggestion that if we respect Von Neumann and Morgenstern rationality conditions, it is possible to observe the preferences of two agents over a set of lotteries in which the two agents have preferences over social states, see *Playing Fair* (Cambridge: MIT Press, 1994) 132-3; 280-1.

²² W. Riker, *Liberalism Against Populism*, id. at 238-239. To be sure, numerous theorists, in response to Riker's claim, have attempted to design legislative frameworks without relying on a majoritarian or foundational basis to legitimate the outcomes of a democratic system. See generally, J. Cohen, 'An Epistemic Conception of Democracy', *Ethics* 97, 1 (1986) 26-38.

10.3 Rational Choice Visions of Democracy

The purpose of this section is to provide an account of the key features of the rational choice approach to democracy. Like the populist approach, the rational choice model looks to substantive political principles to coordinate social conflicts.²³ Our interest in the rational choice framework is to show that the boundaries of the cooperative scheme tend to exclude certain groups (and their non-strategic concerns) as partners in cooperation. I shall argue that under certain conditions rational actors will fail to ground their actions in contracts or bargains. First I will try to separate out the conception of democratic politics that is embedded in rational choice theory. In this section I go on to show that the rational choice vision rests on a model of politics which stipulates that political choices should reflect the utility maximization of the individual. I argue that this framework, based on constrained maximization, breaks down. It is suggested that the rational choice vision of democratic institutions cannot adequately account for the historically contingent political and social processes.

10.3.1 Contract: Between Rationality and Morality

Under the rational choice theory dominant in political theory for the last twenty years, political theorists have employed the contract device to argue for the legitimacy of political institutions, which have a specific purpose and structure. This theory derived from the theory earlier developed in philosophy by Hobbes, Rousseau, and Kant attempts to determine the goods which could be secured by people based on rational agreement. It asserts furthermore that the terms of the agreement (i.e., principles of justice) serve as the neutral standpoint for assessing social structures.²⁴ Ironically, rational choice theorists, despite the lack of actual bargaining, insist that the principles of justice are the product of a bargain between the parties in an original choice situation.

The theory, as originally articulated, asserted that there exist no mechanisms for enforcing agreements or promises. In this sense, compliance is thought to be spontaneous or decentralized. A self-enforcing agreement is a sequence of outcomes in which neither player has an incentive to deviate unilaterally from his equilibrium strategy. However, because there are conditions when individ-

²³ A. Arato, 'Forms of Constitution Making and Theories of Democracy', *Cardozo Law Review* 17, 2, (1995) 222-3.

²⁴ There is a slight difference in views around this point. Rawls insist that parties agree on the principles for assessing social structures, whereas Gauthier has them agreeing on the design of the social structures. See, K. Binmore, *Playing Fair, Game Theory and Social Contract*, Vol. I (Cambridge: MIT Press, 1994) 12-16.

uals could benefit from pursuing a strategy of noncooperation, collective action problems emerge. A central task for the theory, therefore, is to explain why individuals would pursue a cooperative strategy, particularly when there is insufficient information or asymmetric rewards.

The rational choice model endorses the hypothetical bargain rationale as a regulative ideal for dealing with the problem of conflict and cooperation.²⁵ This model, as it has been deployed by contractarian political theory, tests the circumstances under which rational individuals (e.g., at least minimally rational) would agree to a particular social arrangement. The features of justice are thought to follow from the course of self-interested bargaining.

The hypothetical agreement is based not on actual but counterfactual consent, i.e., what rational, forward-looking parties with perfect information would do for achieving their goals. An important assumption is that individuals make their choices independently and simultaneously. The nature and extent of actors' rationality, along with how much information they have about possible outcomes and the resources they possess, will shape and structure their choices. Under the contract principle, individuals are free to pursue their rational self interest in choosing other agents to pursue mutually advantageous behavior. Accordingly, the primacy of contract implies that state is the product of like-minded individuals that form cooperative enterprises to advance their self-interest.

Contractarianism is not without its shortcomings. Given the assumptions of rationality and perfect competition, there is little reason for utility-maximizing individuals to give up their potential gains in favor of agreement and compliance with a joint welfare maximizing strategy.²⁶ In a sense, the general structure of hypothetical individuals in the hypothetical scenario will produce a Prisoner's Dilemma. A Prisoner's Dilemma does not always arise is the response of rational choice theorists. Many contract theorists have argued that there is a potential solution to the Prisoner's Dilemma if we take into account the role of morality to season the dispositions of self-interested agents to comply with agreements made.

The morality school of rational choice theory looks to forge a link between rationality and principles. The substantive claim is that the principle of justice, which are the product of rational bargaining, provide the foundation for agents complying with the agreement. That is, proponents rely on an instrumental approach to the role of moral rules to provide a foundational vision for guiding

²⁵ G. Kavka, *Hobbesian Moral and Political Theory* (Princeton: Princeton University Press, 1986) 21-26.

²⁶ e can assume, in this situation, that for highly rational individuals noncooperation is the dominant strategy for each party in a single-play Prisoner's Dilemma. In this regard, rational action leads to a Pareto-inferior outcome.

conduct and regulating continued social cooperation. The principles of justice consist of a set of principles which persons could employ to publicly justify their actions and to assess the conduct of other citizens.²⁷ Accordingly, it is argued that political institutions of democracy should be structured so as to induce rational actors to reach a reasonable agreement about a set of principles by which to guide our political behavior. The presence of free acceptability and mutual benefit are the grounds by which rational actors agree to be bound by moral considerations.

David Gauthier is the most prominent exponent of this approach. Gauthier's central insight is the introduction of moral constraints on the utility-maximizing behavior of individuals which may be used to secure a solution to the single-play PD, in that it maximizes expected utility for the person to act accordingly.²⁸ To put the point in specific terms, when markets fail, constrained compliance is a rational disposition for an actor since compliance would produce to everyone an expected utility higher than if everyone directly maximized her expected utility. The concept of rational agreement to principles, required to constrain utility-maximization, is informed by the idea that compliance and the disposition to comply would be rational for fully-rational, idealized bargainers. On Gauthier's view, the purpose of securing an agreement has little to do with providing public claims for individuals' well being. The function of agreement is to establish optimizing constraints on utility maximization.

The idea of direct interaction between moral principles and individual action supposes that there is a relationship between the motivational theory of individuals and the structure of human actions. Yet, why would it be rational for individuals in the state of nature to comply only with moral principles? It might be objected that this claim is an inadequate argument for explaining the motivation of rational agents to comply with bargains, particularly if the initial bargaining procedure failed to rectify (or contributed to) the gains to some in greater proportion than others.

Gauthier responds by arguing that for a rational agreement to arise, individuals must be assured that equal advantage is secured through procedural fairness, otherwise outcomes might be perceived to be arbitrary. The process of stable compliance, then, arises from agreement among rational persons that the controlling practices would create mutual benefit. On this account, stability

²⁷ T. Scanlon, 'The Significance of Choice', *The Tanner Lectures on Human Values* (Salt Lake City: Utah University Press, 1987), 149-216.

²⁸ To resolve the PD problem, Gauthier looks to the distinction between directly and indirectly utility-maximizing behavior. The idea is that, in order to overcome the PD, it is rational to comply with utility-maximizing agreements, even though there will be exceptions when compliance yields less utility. See D. Gauthier, *Morals By Agreement* (Oxford: Oxford University Press, 1986) 177-79.

is achieved not by coercion but on the considered judgment of individuals. But the constrained solution to the failure to secure agreement is too simple. Gauthier's approach does not produce a reason why a rational agent would find it rational to selectively cooperate when it would make sense to defect. We should notice that Gauthier is attempting to locate a rational basis for agreement based on the insight that compliance can be achieved by an internal solution.²⁹ The idea of an internal solution is achieved by a change in preference by the individual agent.

These theories suppose that the compliance problem is resolved when a sufficient number of individuals are disposed to toward compliance. Given the assumptions of self-interest and morality, and the dominance of noncooperation on a single play, it follows, according to Gauthier, that a player will cooperate in the state of nature only if doing so he believes that the bargain is fair and impartial. It follows that a fair scheme will tend to induce cooperation of a large number of players which will make everyone better off. This argument can be generalized in two ways. First, only schemes that are fair will attract compliance. Second, it follows that if there is every reason to cooperate on that play, then it is rational for all players to cooperate, provided that compliance is rational.

This argument is paradoxical. It seems that for truly rational parties it would be implausible that in all circumstances inducing cooperation would be rational. This is because the parties would only move together under the most unrealistic assumptions about their starting point in the state of nature. We must assume that, players, in order to determine whether cooperation is optimal, will make a realistic estimate of the benefits of cooperation versus defection.³⁰ Hence, if players are somewhat irrational (by choosing short term gains over long term) we can expect that they will not follow a cooperative strategy.³¹ It should be clear by now that contractarian theorists are unable to avoid the free rider problem by recasting the solution in terms of compliance with moral principles. We have seen that Gauthier's bargaining outcome is unlikely to create a unique equilibrium in the name of justice.

²⁹ J. Coleman, *Risks and Wrongs* (Cambridge: Cambridge University Press, 1992) 54.

³⁰ J. Coleman, *Risk and Wrongs*, p. 56.

³¹ The problem with this approach is that it is static. It depends on there being a sufficiently low probability of conflict between direct and constrained maximizers. However, if there is a sufficiently high rate of increase in the population of direct maximizers, due to shifting dynamics in favor of uncompromising strategies, the relative value of compromise will decrease. See G. Kavka, 'Why Even Morally Perfect People Would Need Government', *Social Philosophy and Philosophy* 12, 4, (1995) 12-13.

10.3.2 Constitutional Contracting

It would seem that the overall strategy based on rational bargains and rational agents is unlikely to lead to realistic insights about the strategic structure of conflict and cooperation which is at the heart of constitution making. That is, many of the coordination problems regarding political power, the distribution of resources, the production of public goods, etc. take place in political society where actually rational individuals select political structures which reflect their wealth and place in society. The problems of collective action are resolved based on the ability of the majority to institutionalize its particular conception of the good. The procedural rules are, along with material resources, organizational skills, and information, important factors in determining which group is able to surmount its collective action problem to exercise disproportionate influence in negotiating the institutional structures of government. The political system is characterized by the competition among different groups to strike a bargain which is stable and self-enforcing.

How, given the contractarian's limitations, can we safely assume that rational actors ground their political choices in cooperative arrangements? If that assumption is unsafe, it may be that the problem of finding coherent principles of justice for the most important political institutions of the state cannot go forward based on rational actors being in a hypothetical choice situation. It is not self-evident that questions of cooperation are solved by reference to rationality or fairness. Moreover, we cannot simply isolate the mechanism of cooperation from the distributional dimension which political players face. In particular, how can we understand the ability of individuals to sustain cooperation without looking to their environment, whether or not their potential cooperators are part of the same political community, etc. We cannot hope to explain the dynamics of democratization, which involve conflict and cooperation, without recourse to the setting in which democratic deliberation is undertaken.

In developing an alternative explanation for the design of democratic institutions, liberal theorists have, in devising a principle-oriented perspective, incorporated the personal characteristics of the parties, their competitive environment and the particular political, economic and preference-shaping influences. Late Rawlsian theory, for example, looks to the promising idea that, under great uncertainty and with much at stake for the participants, the actors engaged in the bargaining would more be more likely to agree on a minimum condition if the veil of ignorance was partially lifted. This analysis turns out to be satisfactory when applied to the actual constitution-making process insofar as the selection process derives from some of the ideas of

society and political views of the constitution makers.³² Employing the insights of Rawls' political liberalism, Arato, for example, argues that the diverse Eastern European Round Tables were designed to account for what the participants thought of themselves despite the pluralism that defines those societies.³³ Naturally, Arato argues that, constitution-making, in order to achieve its mission, must be the object of properly constitutional assemblies in order to strike the proper balance of power in producing an outcome which is reasonable and suitable for public justification.

This section can be summed up as follows. Social contract theories attempt to explain the conditions under which a utility maximization outcome can be achieved. Hypothetical individuals in the state of nature confront the problem of cooperation. Given that these actors have very real incentives to defect, since the potential gains are large, rationality requires that they act in their own interests. However, an internal solution to the problem, based on the individual changing her motivation or preference, does not solve the collective action problem. We have seen that Gauthier's theory does not explain why in many situations it would be very costly for all members of the community to cooperate. The conclusion is that the solution to the problem lies with institutions and a liberal decision making procedure which is capable of taking account of the social, cultural and political contexts and which become represented in the constitutional regime.

10.4 The Social Context of Political Conflict and Cooperation

In their discussion of sovereignty by institution, rational choice theorists, as we have seen, are primarily concerned with analyzing the internal conditions under which individuals would agree to engage in forming institutions. The central premise of the rational choice perspective is that the coherence of a polity is premised on the individual's decision to consent to participate in a group concerning the direction of the common good of society. It is assumed that the members of civil society have achieved a certain level of pre-political unity in order to satisfy the level of cooperation necessary to transform the people into a constituted power.³⁴

³² Rawls' constructivism has been extended to constitution making. J. Rawls, *Political Liberalism* (New York: Columbia University Press, 1993) 127.

³³ A. Arato, 'Dilemmas Arising from the Power to Create Constitutions in Eastern Europe', *Cardozo Law Review* 14, 3-4 (1993) 676-80.

³⁴ It is not surprising that attempts to reinterpret the constitutional transitions in Eastern Europe along popular will have failed to provide viable insights about the design of constitutional provisions to deal with subgroup conflicts. See generally, U. Preuss, 'Constitutional Powermaking for the New Polity: Some Deliberations on the Relations

In this section, I will show that the rational choice conception must be revised to account not only for a wider view of rationality. I go on to suggest that consequence-oriented approach to rationality, which relies on a single utility assumption, is unable to account for the incommensurable public values which are important for constitution making. Among the alternatives to rational choice theory, I look to the normative-expressive approach as a basis for understanding social action. This strategy acknowledges that public values may often be in conflict and, as a result, there may be situations in which political choices are made despite the deep disagreement of certain groups about the values at stake. An approach which looks to norms rather than a consequentialist logic opens up the way for a concept of democratic choice which acknowledges competing claims and judgments about the relative worth of public policy options.

10.4.1 Conflicting Visions of Rationality

As we have seen, the rational choice perspective focuses on the mechanisms of individual and collective choice in order to show how agency behavior leads to social outcomes. Social decisions are described in terms of social welfare functions. A social welfare function serves to evaluate states of society in terms of their highest welfare function in the aggregate. The theory goes on to emphasize that the ordering of political outcomes is not connected to desirability of the social outcome. In this regard, social choice functions reflect individual preferences about different political outcomes. The consequence of this argument is that public choice is defined along one line of value.

But, the fact that a large number of political actors hold a range of diverse values which can not be expressed in terms of a social welfare function suggests that the view of rationality, endorsed by rational choice, is insufficient. The crucial step is that groups may have beliefs whose contents, while significant and cause for conflict, may not be assimilated within the outcome-oriented conception of rationality. Of course, if we look in more detail to the values of different groups and their particular expression, it might be possible to develop an account of political choice which is divorced from outcome-oriented rationality. The attractiveness of this viewpoint is that the introduction of diverse, and often conflicting values, means that individuals will select courses of action consistent with their backgrounds and assumptions. As a result, the principle of instrumental rationality is challenged.

The rational choice literature assumes that an instrumental conception of individual rationality — social choices are the result of a single preference

ranking — is the best mechanism to explain social practices or institutions. It is assumed that an ordinal preference ranking could be constructed which reflected the rational choices of individuals in society. The possibility of ordering preferences is informed by assumption that preferences are transitive. Transitivity here means only that there is consistency with regard to preference orderings.³⁵

At the same time, because preferences are ordinal, it is assumed that preference intensity is irrelevant. Preferences are also thought to be stable over time. As it stands, rational choice theory is informed by the assumption that each individual's private preferences are fixed and stable and, given sufficiently full information, they will be able to select the course of action which reaps the highest expected utility.³⁶ Proponents argue that rational action requires that some preferences schedule is maximized. Thus, rationality, in this sense, means roughly that an individual's preferences can be translated into a single preference ranking, in which choices are measured in terms of their social consequences. Hence, the aim of rational choice theory is explain consequences in terms of the maximizing actions of individual agents.

Recently, the traditional conception of rationality has been revised along two lines. In the first place, the image of rationality itself has changed. First, it has been noted that even the term 'rational' is ambiguous.³⁷ We must be clear what type of rationality we are talking about. Gibbard imagines that there

³⁵ To make this discussion less abstract, an example of a transitive preference ordering is the following: If A is preferred to B, and B is preferred to C, A is preferred to C.

³⁶ The question of how much information that the individual should have goes to the concern of maximization of outcome. If there is too much information, which creates the opportunity for conflict, the level of information should be restricted. This is the route which Rawls took to overcome theoretical problems in the model. More recently Gibbard argued that even if an individual agent has full information, which she often does, only part of it will be employed in making a rational decision. Gibbard urges that we think of the full information requirement in terms of advisability; that is, rationality, thus defined, means 'acting in full and vivid awareness of whatever information one has'. A. Gibbard, *Wise Choices, Apt Feelings* (Oxford: Clarendon Press, 1990) 19.

³⁷ For example, Elster observes that there is no fundamental model of preferences and rational belief. Extending this argument, he notes that there is no clear idea of what irrational beliefs and action mean in politics. This argument is sceptical of the view that political action stems only from the acting out of reason. While individuals try consciously never to act against their own self interest, Elster furnishes us with the insight that political action often arises from weakness of the will. There should be nothing to surprise us about this conclusion since there are numerous democratic mechanisms or precommitment devices that have been designed to stabilize society against certain actions that are the result of political irrationality. J. Elster, *Solomonic Judgements, Studies in the Limits of Rationality* (Cambridge: Cambridge University Press, 1989).

are two levels of discourse about what the word rational means. The first is the ordinary semantic level: what does the term rationality mean. If you disagree with the definition of rationality, it may be that you have a different view about what it means to be rational. However, it would be wrong to confuse the definitional question with the substantive issue of the nature of rationality.

At the second level, according to Gibbard, rationality should be tied to social norms. In tying rationality to social norms, Gibbard thinks that individuals acquire their rational aims by following a norm which they care to be governed by. His position is interesting because it involves an expressive account of rationality: That is, rationality reflects the expression of an attitude. The expression of attitudes is not a theory of truth about rationality since it looks only to individuals expressed valuations and not the truth about what is rationality. The importance of the norm-expressive account of rationality is that it rejects an agent centered view of rationality, that is, it emphasizes that social norms (contexts) are the mechanisms of rationality. At the same time, it injects scepticism about the whether there is an determinate property of rationality.

It is easy enough, based on Gibbard refutation of the narrow self-interested theory of rationality, to insist that the hypothetical rational individual, endorsed by rational choice proponents, is no longer a plausible basis upon which to develop a theory of rationality. Once we make this adjustment, the level of rationality attributed to the individual, to the extent that it impacts choice, is significantly reduced.

10.4.2 The Commitment to Other-Regarding Values

The idea of a direct impact between social norms and rationality suggests a new approach to rational action. It would seem that this new project, which redefines the concept of rationality, must look to all forms of norms as a mechanism to solve problems of outcome-oriented social choice.³⁸

A more acceptable notion of rationality might be one in which nonconsequentialist norms could be a motivation for behavior.³⁹ This account suggests that norms may be individually rational to follow and allows for the fact that certain norms may be more contribute more for individual action than others. Indeed, the mixed model of rationality, significantly, acknowledges that outcome-oriented motivations are very effective in guiding behavior. But the

³⁸ J. Elster, *The Cement of Society, A Study of Social Order* (Cambridge: Cambridge University Press, 1989) 97-151.

³⁹ See generally, D. Schmitz, 'Reasons for Altruism', *Social Philosophy and Policy* 10, 1 (1993) 52-68.

scheme breaks ranks from rational choice theory by proposing to account for behavior which is not exclusively guided by rational considerations. The implication is that certain values will not easily translate into a hierarchical preference ordering.

To make this idea concrete, consider the problem of political participation in the transition to democracy. At outset of a revolutionary process, the rational actor, according to rational choice theory, always endorses the status quo and leave political action to others. Yet it is widely accepted that revolutionary movements tend to attract a range of individuals who have their own incentives for joining a movement (from non-instrumental to self-interested behavior). This presents a problem for rational choice theory. In order to avoid this objection, proponents insist that participation is guided by incentives, which accounts for their involvement over time. But this precisely leaves out altruism as a motivation. Elster suggests that it is possible to envisage a situation in which the revolutionaries, by committing themselves to future behavior which could turn out to be against their self-interest, are affected by complex motivations (e.g., altruism).⁴⁰ Thus, we must recast political choice not in terms of issue by issue decision-making, conceived in terms of instrumental ends, but as the process of individual interaction which is embedded in social relationships which are capable of altering the payoff structure of the agent.

As we have seen, norms often coincide with self-interest as they shape actors' conduct, but they never fully reduce to explanation in self-interested terms. With this last point, the pluralist approach asks us to reconsider the rational actor itself. Given the need for the stabilizing role of norms, it follows that an exclusively egoistic model of the actor suffices as a basis for explanation no better than does an exclusively altruistic model. Only a mixed model of the actor works well. This complex actor still may be conceived as a utility maximiser: He may derive satisfaction from counterpreferential choices, a satisfaction stemming from a balance of self-interested and social motivations.

Consider a political community's judgement about whether to invest resources into a particular program. The decision to invest could just as easily be linked to a community's other-regarding concerns (i.e., source of pride, commitment to a shared well-being, or a conception of the future) which does not yield a cost-benefit calculation.⁴¹ To see how this challenges the rational choice view, recall that earlier discussion of preferences. Having policy options that are based on incommensurable values suggests that a determinate prefer-

⁴⁰ J. Elster, *Political Psychology* (Cambridge: Cambridge University Press, 1993) 19.

⁴¹ R. Pildes and E. Anderson, 'Slinging Arrows at Democracy: Social Choice Theory, Value Pluralism, and Democratic Politics', *Michigan Law Review* 90, (1990) 2160-2162.

ence ranking reflecting the collective choice is not possible. Should there exist significant disagreements over the course of a political action, the presence of inconsistencies may only reflect a disagreement over the options. But, if the disagreement is fundamental and there is no rational ranking of options possible, it follows that a collective choice could not be made which reflects the rationality of the collective.

We have seen that the rational choice account of rationality states that individual action is guided by preferences which are linked to the realization of a Pareto-efficient outcome. Under optimal conditions, we can say that actors will engage in utility-maximizing behavior, and it would be irrational for them to pursue different goals which are incompatible with self-interested behavior. Since we know that the utility-maximizing behavior of individuals can lead to Pareto-inferior outcomes,⁴² we have looked to norms to coordinate expectations. In place of individual rationality, we conclude that social norms and practices provide the background against which individuals make value rankings. In this regard, rationality is not solely linked to one hierarchical value but rather is the result of a range of social and political practices. This section describes the idea that a source of value can be the commitment which political actors have for principles which reflect our feelings and concerns. They may involve larger concerns which involve a potential for political reflection.

10.4.3 Pluralism and the Limits of Value Reductionism

The traditional model has been criticized for attempting to reduce collective and individual aspirations and values to one motive. According to rational choice theory, the content of public policy and the shape of institutions must be based on a single evaluative structure. Much of the critical discussion of rational choice theory can be seen as attacking the single utility assumption.⁴³ Critics argue that there are multiple utility frameworks which reflect the diverse values and social roles of individuals. On this account, because there is no standard method of determinate ranking, conventional accounts of rationality are, at best, limited or, at worst, mistaken. That is, insofar as there is no all-encompassing measurement or ranking which can be employed to rank alternatives involving different values, there is no *ex ante* decision procedure for lexically ordering between higher and lower order public values. Hence,

⁴² J. Kraus and J. Coleman, 'Morality and the Theory of Rational Choice', in P. Vallentyne (ed.) *Contractarianism and Rational Choice, Essays on David Gauthier's Morals By Agreement* (Cambridge: Cambridge University Press, 1991) 256.

⁴³ J. Raz, *The Morality of Freedom* (Oxford: Clarendon Press, 1986) 322-28.

the existence of incommensurable values challenges the claim that the consistent and transitive preference ranking is theoretically the most appropriate vehicle of social choice procedure, particularly since certain values and perspectives are inevitably not incorporated into value rankings.

Note that these theorists argue that the idea of incommensurability does not mean that values can not be ordered and compared. To the extent that it is inevitable that certain values are going to be ranked suggests that there is a weak sort of comparability operating. Indeed, it would appear that trade-offs are possible. However the problem, in practice, with trade-offs is that they are done so in an inconsistent fashion. Furthermore, the fact that there are trade-offs reflects that only a certain range of comparisons are permissible. The defence of diversity, and the respect of groups or collective goals, is founded on the concept of toleration. Thus, in the face of no higher order system of ranking values, diversity is tolerated on considerations of fairness.⁴⁴

The upshot, is that value pluralism, unlike the rational choice-centered approach, insists that the political institutions must treat people equally and that neutrality operate as a regulative political ideal. Pluralism, unlike social choice theory, operates to ensure the possibility of political legitimacy in the face of a mixed system of values and interests. We have seen that pluralism offers an alternative framework to rational choice theory. This approach argues that institutions unavoidably interfere with and contribute to the deliberative choices of individuals. Most obviously, the fact that individuals' preferences are adaptive and dependent on a wide range of considerations, including utility-maximization, suggests that the motives for action are the result of a cluster of social norms, which are not easily reduced to an instrumental calculation. Moreover, the fact that individuals are part of a culture which supports diversity and differentiation lead us to the conclusion that 'individual rationality cannot be realized simply through private reflection on one's personal preferences; it emerges from social and political struggles that reshape the meanings and demands of our roles and practices'.⁴⁵

No doubt these arguments supply strong reasons for preferring an account of democratic decision-making based on multiple preference frameworks and a socially-grounded conception of the individual that is structured by social norms and institutions. While there may remain certain advantages in applying rational choice techniques to collective action problems, I have argued that the

⁴⁴ Rawls' theory of 'justice as fairness' reflects a commitment to a political conception of justice which eliminates the so-called metaphysical ideals and substitutes it with a practical framework in which a shared public basis for the justification of society's institutions will emerge. See generally, J. Rawls, *Political Liberalism* (New York: Columbia University Press, 1993).

⁴⁵ R. Pildes and E. Anderson, 'Slingshot Arrows at Democracy, *ibid.* 2178.

framework is not sufficiently robust to capture the diverse causes which influence our decisions and under certain conditions leads to irresolvable conflicts.

10.5 From the Rationality of Contract to Institutions

The analysis so far has considered the case of the rational individual. In reality of course the actors are not abstract individuals but rather political organizations, interest groups and other associations which join together to overcome collective action problems in order to obtain public goods, etc. Rational choice theory assumes that any social group will construct a coherent collective will and pursue an agenda based on a preference ordering. Yet in the real world, groups rarely maintain a collective and coherent general will. Their preferences are formed within the context of democratic institutions which contributes to their ability to engage in political choice. Recent work has suggested that institutions are crucial for solving the problem of democratization. This section will critically evaluate Przeworski's rational choice approach to democratic transitions. I question whether his analysis of institutions completely solves the problem of conflicting visions of the democratization process.

10.5.1 Democratic Transitions

When social and political conflicts emerge, as they did with the Eastern and Central European revolutions of 1989, the political groups leading the transformation process will endeavour to secure their achievements by establishing an institutional framework that reflects the new distribution of power. Transitions to democracy are negotiated with the incumbent forces and the dominant groups involved in social change. The negotiation process is determined by the underlying distribution of economic and social resources, as well as the existing institutional arrangements.⁴⁶ A democratic transition is characterized by interest group bargaining over the precise contours of institutional choice.

Przeworski's account of democracy is conceived in terms of a competitive struggle amongst the political forces engaged in a conflict over design of the rules of the game. His defence of democracy is premised not on philosophical justification about people's ends. Rather, the principle at work here is an instrumental conception of political institutions. The orienting idea is that since there are diverse political ends in society, democracy requires that there should be as many institutional arrangements available for groups to pursue their own

⁴⁶ A. Przeworski, *Democracy and the Market, Political and Economic Reforms in Eastern Europe and Latin America* (Cambridge: Cambridge University Press, 1991) p.81.

ends without penalty. Przeworski's notion of a constitutional transition to democracy is premised on the intuition that a democratic outcome can be achieved only if the conflicting and competing political organizations can agree to a compromise framework that permits constrained competition, and self-enforcing compliance with the rules of the game.

But, democratic transitions are difficult to organize particularly since political associations, which are created to obtain benefits for their members, must, despite the individual rationality of their members, cooperate with other groups to create new political institutions. For rational choice theory, the problem is thought to require a self-enforcing solution to what is essentially a one-shot Prisoner's Coordination problem.⁴⁷ But, as earlier noted, a resolution of the Prisoner's Dilemma, even under conditions of perfect information and full rationality, will not emerge with conditional strategies. Rather, it is the existence of ongoing institutions and informal enforcement mechanisms (e.g., reputation) which offer a more serious attempt of resolving the coordination problem.

Typically transitions involve intense interest group bargaining over the voting rules, structure of government, associational rights, the judiciary, and other decision-making powers. We can not expect a compromise because the political actors are aware that the newly developed institutions will affect not only the distribution of resources and power, but influence, as well, the future rounds of political bargaining. Typically, parties will, in the course of negotiations, pursue their own self-interest, and engage in a coordination game in order to pursue optimal outcomes. But since the groups have different information and commence bargaining from different material positions, it is unlikely that the search for a unique equilibrium will be facilitated by an open exchange of information and trust between the parties. Rather, given that the bargaining process is about absolute competitive gains, the tactics of the parties are unlikely to produce a normative solution which is compatible with cooperative gain. In other words, the outcome of the democratization process is not only a matter of efficiency.

The search to establish an institutional agreement creates difficulties in that the legitimacy of an outcome does not depend on all groups acquiring the same disposition to cooperate. To be sure, to win control in the political competition depends on the creation of a significant majority of the groups which, despite their diverse preferences, agree to a compromise. But, the reintroduction of democracy is possible only if the agreement is institutionalized into the political structure that reflects the strategic interests of the parties to the agreement. In effect, the competing groups will not acquire a disposition to cooperate unless

⁴⁷ See P. Ordeshook, 'Some Rules of Constitutional Design', *ibid.* 200-1.

they are similarly disposed or there already exists monitoring devices and institutions to enforce the agreement. The outcome of the transitional process therefore reflects the successful strategies of political groups which are linked to interests via the process of institutional choice. In this regard, the hard-wiring of the design and structure of the legislative and administrative institutions by the newly formed coalition can work to limit the chances that future changes in the social and political circumstances can upset or alter the original framework.

We have seen that neither contracts nor pacts are sufficient to enforce democratic compliance. This is not a happy result for rational choice theory. But the introduction of a punishment strategy could deter actors from cheating and promote the emergence of a decentralized compliance. Recent contributions of game theorists have led to a simple set of punishments and rewards that yield the maximal cooperation which can be supported given the possibility of defection. The theory is based on a punishment path which punishes harshly for just enough periods so as to wipe out the original gains from cheating and then forgives totally and reverts back to the cooperative path.⁴⁸ Credible punishment strategies support the insight that cooperation can work in less than perfect conditions. The upshot is that compliance can be self-enforcing if there is an institutional structure which is designed to satisfy the information requirements to enhance effective compliance. Przeworski argues that democracy is consolidated only when the institutional framework is self-enforcing.

The reintroduction of uncertainty is a defining feature of a successful transition to democracy. Not only must political outcomes be indeterminate but there can be no guarantees that ensure that one group prevail at the end of the day. Democratization represents the credible commitment of social forces, embedded in the institutional structure, to regulate and promote political competition while ensuring, at the same time, the production of contingent consent. But, can this view of democracy be defended? I don't think so. Such an account of democracy is founded on the idea that the political framework is sufficiently plastic and free of the path dependent evolution of institution practices that it can be re-wired from time to time in order to release the forces of political competition. To put it simply, the problem is that once an institution becomes embedded in society it gains strength not only from its efficiency but from its development and interdependence with other sub-systems. Thus, democratic reform not only entails costs of establishing a new set of rules but the problem of releasing a chain reaction in the other components which remain in place.

⁴⁸ D. Abreu, 'External Equilibria of Oligopolistic Supergames', *Journal of Economic Theory* 39 (1986) 191-225.

In practice, it would seem that the political institutions have played a central role in constructing the context against which democratic reforms have meaning or cohere. That is, in the course of a democratic transition, the success of large-scale economic reforms and their speed is crucially dependent upon political constraints.⁴⁹ On this view, democracy is understood in terms of a brokerage system in which interest groups and suppliers are brought together, through informal agreements based on incentives, reputation, and punishment to promote durable institutional arrangements which secure a stable level of welfare for the groups party to the agreement. The problem with this argument is that it concentrates on linking design and political interest while it offers very little in the way of evaluating the efforts at institution-making. One might try to defend Przeworski's account of the transitional process by arguing that linking the role of interest to institutional design he has opened up the way for an account of political institutions which is based on a historically contingent political process.

But, the major problem with Przeworski's account is its reliance on an instrumental model of rationality. By linking self-interest to motivation, he narrows the range of motivations by which individuals and groups might act. This approach is partial, in that it excludes other-regarding values and is committed to an economic explanation for the explaining the structure of choice. The commitment to democracy is complex. It emerges from a range of commitments, including preferences which are not strictly linked to self interest. While strategic goals play an important role in explaining our experience in politics, it is a simple fact that people are driven by principles, integrity and even justice.

10.6 Conclusion: An Normative-Institutional Approach

Let us return to the issue of the rational choice understanding of political institutions. I have argued that the self-interest assumption on which the theory is based is not appropriate for all our commitments. Indeed the individualist approach to rationality runs into problems in that what is rational is not commonly understood by every participant in the political struggle. We have seen that Gauthier's contractarian argument of rational action understood, in terms of the constrained maximization of expected utility, is unsound because it presupposes the level of rationality required to resolve the Prisoner's Dilemma.

At the same time, the that the rational choice approach does not account for

⁴⁹ M. Dewatripont and G. Rowland, 'Economic Reforms and Dynamic Political Constraints', *Review of Economic Studies* 59 (1992) 703-30.

nontrivial reasons for other-regarding motivations. The diversity of values and commitments, which may incorporate both self-interest and other-regarding concerns, are not easily reduced to the satisfaction of a single transitive preference. We have seen that the process of political choice often involves a complex mix of these concerns. The commitment to democratic choice should be to cultivate these commitments. Rational choice theory fails to recognize that multiple preference rankings can be reconciled by a range of mechanisms: role differentiation, decentralized political institutions, and political associations. It is not plausible to expect that these structures can create solutions for all the substantive disagreements regarding politics or national identity. But, again we should recognize that the institutional design is crucial in creating the conditions that enhance the further expression of these values.

From the point of view of pluralism, we have seen that the establishment of new democratic processes requires the forging of institutions which can effectively coordinate the expectations of diverse political groups. In designing agreements, the problem of enforcement is crucial. The device of contract can not solve the self-enforcement problem. Rather, it was argued that the institutions which emerge are usually the product of interest group bargains, which tend to exclude the interests of the relatively weak members from influencing the design and direction of democratic structures. Constitutions can provide the basis (e.g., property rights) to induce an equilibrium. It was argued focal point norms (and other carrot and stick strategies) can also serve to support self-enforcement where there are multiple outcomes are possible.

The problem with relying on the focal point concept is that it fails to provide a mechanism for how a significant group of individuals come to follow a norm, nor does it explain why people adhere to it. It follows from our earlier discussion that it may be possible to expand on the focal point concept, using a wider variety of social norms to supplement the missing explanations in the theory.⁵⁰ Thus, the norms of reciprocity, equality, and cooperation could operate much like focal points in that they can induce predictable outcomes. Some of the devices are even consistent with the rational expectations framework mentioned earlier. But, it was argued that while norms may coincide with self-interest, they never fully reduce to explanation in self-interested terms. Hence, the introduction of norms provides a realistic basis for remodelling the rational actor itself based on a mixed model of rationality.

We have also argued that the reliance on norms to enhance coordination requires effective institutions. Institutional tend to reduce asymmetric informa-

⁵⁰ S. Majeski, 'An Alternative Approach to the Generation and Maintenance of Norms', in K. Cook and M. Levi (eds.) *The Limits of Rationality* (Chicago: University of Chicago Press, 1990) 273-81.

tion (by identifying past mistakes, opportunism, etc) and limit transaction costs.⁵¹ We have seen that in the real world of politics, institutional structures also provide a low cost basis for the members of a political community to establish differentiated social roles. With this last point, we should begin to think of the task of resolving conflicts in terms of a problem of the design of institutions since they often provide the material foundations for the emergence norms of cooperation.

⁵¹ G. Garrett and B. Weingast, 'Ideas, Interests, and Institutions', *ibid.* 176-77.

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